OVERVIEW

Economic and Financial Developments in the Malaysian Economy in the First Quarter of 2003

First quarter growth within expectations...

The Malaysian economy has remained resilient despite an external environment marked by heightened uncertainty and the impact of SARS on regional economies in the final part of the quarter. Real GDP growth of the Malaysian economy in the first quarter of 2003 was within expectations. Economic activity expanded at an annual rate of 4% compared with 1.3% in the corresponding period last year. Expansion was positive in all sectors.

Growth in the first quarter was largely supported by domestic demand, underpinned by stronger public sector spending. Export performance remained strong in several sectors, reinforcing domestic demand. Expansion of monetary aggregates, especially M1, reflected the strong domestic demand. Further growth in bank lending and stronger expansion was seen in loans to small businesses.

A combination of accommodative monetary and fiscal policies, low inflation, a stable job market as well as higher commodity prices were factors supporting domestic demand during the quarter. Domestic demand was underpinned by higher public sector spending on emoluments, and supplies and services. Private consumption spending also showed a resilient trend, supported by extensive retailers' promotions sustained by growth of disposable income and positive consumer confidence. An important factor was the continued positive growth in gross fixed capital formation. Higher public sector investment was expended on education, health and infrastructure development. Forward-looking indicators such as MIER Business Conditions Index, consisting of orders and anticipated production, as well as high bank loan approval rates signalled that investment activities could improve as uncertainties abate.

Sustained growth in all economic sectors

Growth in the first quarter was marked by continued expansion across all sectors of the economy with the main impetus emanating from the manufacturing and services sectors. The manufacturing sector expanded by 5.2%, supported by stronger growth in the domestic-oriented industries and expansion in the export-oriented industries. This was reflected in the higher capacity utilisation rate in the sector of 82%. Export and domestic-oriented industries operated at 83% and 80% respectively.

The overall services sector continued to register a relatively strong growth of 4%, supported by domestic demand and trade-related activities in tandem with the sustained expansion in exports. In particular, growth in the transport, storage and communication sector strengthened, underpinned by strong expansion in the telecommunication sector, as well as robust growth in port and trade-related activities. Similarly, the wholesale, retail trade, restaurants and hotel sector performed better, supported by domestic demand.

Construction sector activity expanded by 1.2%, supported by public sector projects and continued demand for housing, amidst an improving labour situation. The return of foreign workers enhanced expansion in construction activity. Output from the mining sector continued to increase, underpinned mainly by expansion in natural gas production with the coming onstream of the MNLG 3 plant in March, as well as continued growth in crude oil production. The agriculture sector continued to register a positive growth despite the weaker crude palm oil production. The sector was supported by higher production of other major commodities such as rubber, saw logs and cocoa amidst the favourable prices and strong external demand.

Inflation remained low while labour market remained stable

The annual increase in CPI averaged 1.6% in the first two months of 2003 but moderated to 0.7% in March. This was due to the lapse of the impact of the higher tariff on telephone services implemented in March 2002.

Overall, labour market conditions remained stable during the quarter. As employers expect the slowdown to be transitory and cyclical in nature, the pace of retrenchment and other cost-cutting measures have slowed down. Productivity in the first quarter increased with annual growth in real sales per worker outpacing the growth in real wages.

External position remained resilient

The trade surplus was larger at RM17.6 billion in the first quarter. Export performance remained moderately strong, supported by the upturn in global semiconductor demand. Gross exports expanded by 7.8%, reflecting growth in exports of manufactured goods, agriculture and minerals. In line with strong global demand, exports of semiconductors and palm oil were exceptionally robust. While the volume of Malaysia's crude oil exports was stable, higher export proceeds reflected the war premium on oil prices. Import growth moderated to 2.3%, mainly due to slower growth in imports of intermediate goods. Reflecting the sustained strength in private consumption, imports of consumption goods grew by 4.7%. Excluding lumpy items, imports of capital goods increased by 0.3%.

Tourist arrivals remained steady at 2.9 million for the quarter despite the heightened geopolitical risk. Tourist arrivals were sustained at a monthly average of one million arrivals but declined to 0.8 million in March due mainly to the onset of SARS. The SARS impact, with the issue of the WHO travel advisory beginning mid-March, was more concentrated among tourist arrivals from Singapore and Hong Kong. It is largely anticipated that the SARS impact on tourism is likely to be reduced in the second half of the year.

Based on the Cash BOP Reporting System, gross inflows of FDI in the form of direct equity and inter-company loans (excluding retained earnings) increased by RM3.1 billion in 1Q 2003. In terms of composition, gross inflows of FDI during the first quarter were mainly through inter-company loans. About 60% of the loans were received from a related company by an MNC, through its centralised treasury operations in Malaysia. Direct equity inflows continued to be channelled into the manufacturing sector and the oil and gas sector. Outflows of FDI during the first quarter reflected largely the higher repayment of short-term inter-company loans, and payment for an acquisition of foreign interests in the gas sector. After taking into account the gross

outflows, FDI recorded a net outflow of RM3.3 billion. As outflows were mainly to fund the change in ownership of business interests from non-resident to residents, the FDI flows did not adversely affect economic activity in Malaysia. Meanwhile, net overseas investment recorded a lower outflow of RM1.1 billion (4Q 2002: -RM2.1 billion), led by investments into the oil and gas sector and the manufacturing of composite component parts for the aerospace industry. Outflows of portfolio investment was much lower at RM1.6 billion in the first quarter.

Reserves increased further

The net international reserves of Bank Negara Malaysia increased to RM132.6 billion or US$34.9 billion as at end-March 2003. The reserves level had also taken into account the quarterly adjustment of the unrealised foreign exchange revaluation gain amounting to US$211 million. Reflecting the sustained strong fundamentals of the economy, the net international reserves increased further to RM139.7 billion or US$36.8 billion at 13 June 2003. The reserves position is adequate to finance 5.7 months of retained imports and is 4.6 times the short-term external debt.

External debt remained manageable

Malaysia's total external debt position stabilised at RM186.8 billion (US$49.1 billion) as at end-March 2003, equivalent to 52.9% of GNP. Although medium and long-term external debt increased marginally, total short-term external debt declined to RM30.9 billion or US$8.1 billion. The lower short-term debt reflected the decline in the revolving credits of the non-bank private sector, arising mainly from the repayment of these loan facilities by several major companies. As at end-March, short-term debt accounted for only 16.5% of total external debt, among the lowest in the region.

Fiscal stance remained expansionary

Budgetary operations by the Federal Government remained expansionary in the quarter, led mainly by substantially higher development expenditure for social and economic programmes. Consequently, the Federal Government registered a higher overall deficit of RM4.7 billion in the first quarter. Nonetheless, the outstanding debt of the Federal Government was contained at 45.9% of GDP (45.7% of GDP as at end-2002). This level of debt remained manageable, with domestic debt accounting for 78% of the total debt.

Accommodative monetary policy continued to support domestic demand

Monetary policy remained accommodative in the first quarter to support domestic economic activity. Interbank and retail rates continued to remain low and stable while liquidity remained ample. In tandem with the continued expansion in economic activities, all three monetary aggregates continued to expand, with M1, M2 and M3 increasing by 8.4%, 5.6% and 6.7% respectively as at end-March. Strong increase in M1 reflected sustained demand for transaction balances. This corresponds to the sustained increase in private consumption.

Growth in monetary aggregates was mainly due to sustained financing activity of the private sector during the quarter. Total gross financing through the banking system and capital market expanded at an annual rate of 12.2%. During the quarter, bank lending activity was sustained with loan disbursements amounting to RM100.4 billion. Loan applications and approvals, the two leading

indicators, increased by 14.4% and 14.1% respectively. A significant development during the quarter was that outstanding loans extended to the small and medium industries (SMIs) expanded further by RM2.1 billion. Meanwhile, total deposits mobilised by the banking system rose by RM1.1 billion during the quarter or 3.2% at end-March 2003. In April, loans and deposits increased further. Consequently, the loans-deposit ratio, including holdings of private debt securities by the banking system, stood at 93.7% at end-April.

In the capital market, total funds raised were significantly higher in the first quarter. The public sector raised funds amounting to RM20.3 billion mainly through issuance of Malaysian Government Securities (MGS). Net funds raised by the private sector amounted to RM15.8 billion, mainly from the private debt securities (PDS) for both refinancing and debt restructuring purposes.

Banking sector exhibited increased resilience

Banking capitalization strengthened further as a result of improved quality of assets and profitability. The net NPL ratio (6-month classification) moderated further to 7% at end-March 2003 while net NPL ratio (3-month classification) fell below 10%, the first time since the Asian crisis. The risk-weighted capital ratio (RWCR) and core capital ratio improved further to 13.1% and 10.9% respectively as at end-March 2003.

Danaharta continued with its recovery efforts to maximize the recovery values from the NPLs with an expected recovery rate of 56% (48% for acquired loans and 63% for managed loans). Danaharta's total recovery collection amounted to RM20.3 billion at end-2002, representing 69% of the total amount that it expected to recover from its portfolio. Danaharta has, up to end-2002, distributed surplus recoveries of RM371.1 million in cash and 55,899,542 units of securities to 30 financial institutions.

Upgrading of the Bankcard successfully completed

An important development during the quarter was the successful completion of the upgrading process for Bankcard by MEPS and local financial institutions. The official launching of Bankcard on 28 February 2003 brings to fruition one of the two types of smart card solutions under the Multipurpose Card (MPC) Flagship Application, which is one of the seven MSC Flagship Applications. As at end-March 2003, more than 1.74 million Bankcards have been issued. Banking institutions are also in the midst of upgrading their ATMs to perform MEPS Cash loading which is targeted to be completed by the end of the second quarter. The ATM and MEPS Cash applications are part of the features of the MyKad, issued by the National Registration Department.

Bank Negara Malaysia is also taking steps to increase consumer understanding and to promote the prudent use of credit cards. In this regard, the Bank has issued a guideline on credit card operations on 18 March giving the issuers of credit cards six months to undertake the necessary system adjustments and ensure compliance. The new guidelines set out the minimum requirements on credit card operations revoking previously issued guidelines and covering new areas such as prudent lending requirements, usage of credit card for unlawful activities, supplementary cardholder's liability, liability for lost or stolen credit cards and placing added emphasis on consumer awareness and education programmes.

Near-term outlook remains favourable

Going forward, the outlook for the second half of the year is for further strengthening of the Malaysian economy. On the external front, the outlook for the major industrial economies in general and the US in particular has improved, although growth is likely to be more modest than earlier expectations. Proactive measures by the authorities in the area of monetary and fiscal policies have been taken to support growth.

On the regional front, the SARS impact has been adverse on specific sectors including the retail, travel and tourism-related sectors. The recent downward revisions on regional outlook reflect the varying impact of SARS among countries in the region. In response, the Governments in the region have announced economic relief packages to mitigate the impact of SARS. It is largely expected that the regional growth would pick up in the second half of the year. In Malaysia, a stimulus package amounting to RM7.3 billion was introduced, incorporating 90 measures under 4 main strategies, aimed at alleviating the impact of SARS and strengthening economic activity.

As part of the package, the 3-month intervention rate was reduced by 50 basis points to 4.5%. Together with the other measures in the economic package to increase disposable income, it is expected to enhance the potential for supporting the growth prospects. The interest rate adjustment represents a pre-emptive measure intended to lend support to strengthen further the domestic growth potential in an environment of a more modest growth in the global economy. With economic fundamentals remaining strong and macroeconomic policy in place to support growth, Malaysia is well positioned to realise its underlying growth prospects.

ECONOMIC AND FINANCIAL DEVELOPMENTS

International Economic Environment

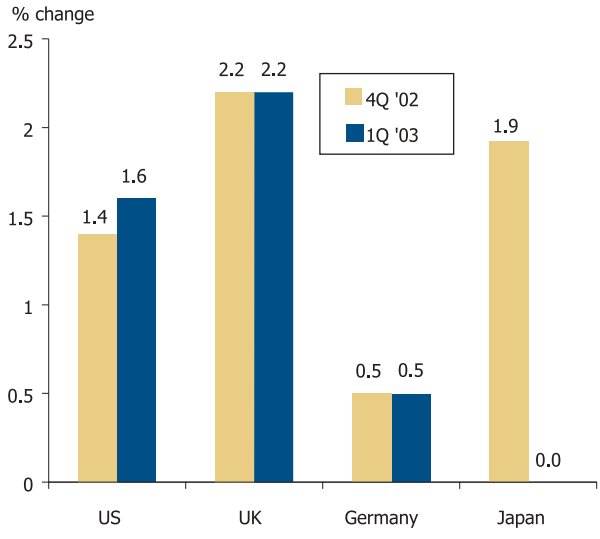
The **global economic environment** in the first quarter of 2003 was marked by significant geopolitical uncertainty. By April, however, this uncertainty abated with the ending of the war in Iraq and the decline in global oil prices. Subsequently, the financial markets in the major industrial countries recovered on optimism of stronger growth in the second half of the year. Notwithstanding these positive developments, global recovery may be weighed down by the uncertainties, including continued geopolitical tensions and the structural imbalances in the major economies. A rapid adjustment to the growing fiscal and current account deficits may impact US growth with global consequences. At the same time, the persistent decline in the US dollar has increased volatility in global foreign exchange markets. Further declines in prices amidst excess capacity in a number of countries raised deflationary concerns and on the effectiveness of current policies to reverse the situation. On balance, however, expectations of positive impact from the current US tax package and other policy actions would result in positive albeit modest growth.

In **Asia**, the outbreak of the Severe Acute Respiratory Syndrome (SARS) largely did not affect growth in the first quarter as it only began in late March. By May, however, it had resulted in significant declines in consumer and business confidence, adversely affecting the travel, tourism, retail and related activities. The economic impact of the SARS outbreak, however, depends on the duration and severity of the health concerns. As of early June, there are indications that the region had probably seen the worst and conditions are now beginning to improve.

Major Industrial Countries: Slower growth in the first quarter. Stronger growth going forward

In the **United States**, the preliminary 1Q GDP data (1.6%) was lower than market expectations (2.3%), due mainly to the lower-than-anticipated government spending and slower consumption growth. Despite the build-up to the Iraq war, government spending was much lower than expected. Moreover, consumption growth in the quarter was the lowest since 1Q 1993, attributable mainly to a slowdown in spending on services following adverse weather conditions. Fixed investment slowed down markedly due to the decline in equipment and software spending, which

Major Industrial Countries: Real GDP Growth



may affect exports from electronics-exporting Asian economies. These developments prompted the IMF to revise downwards its forecast of growth of the US economy to 2.2% in 2003 (February 2003 preliminary: 2.4%; September 2002: 2.7%). By early May, however, some improvements were seen in the latest monthly economic data, including continued consumer confidence, the rise in services sector index, and rising home sales and durable and non-defence capital goods orders. These positive developments more than offset the weakness in the manufacturing sector. Other positive developments include the continued decline in risk spreads in corporate markets and lower energy prices.

While a reduction in geopolitical uncertainty and the decline in energy prices would be positive for growth in the second quarter, concerns over deteriorating labour market conditions and the risk of deflation could threaten growth prospects. The unemployment rate has risen to 6.1% and the weekly jobless claims has remained above the 400,000-level for 16 consecutive weeks, reflecting a weak pace of hiring. Meanwhile, the US Federal Reserve Board (Fed) viewed that, with price inflation already at a low level, substantial further disinflation would be an unwelcome development, especially to the extent that it puts pressure on profit margins and impedes the revival of business spending. Several factors underpin the disinflationary forces. The large excess capacity following the bursting of the equity-investment bubble in 2001 had led to a widening output gap. Weaker labour market and waning effects of tax cut could also have affected consumption in the current period. In addition, investment has remained subdued. However, inflation expectations as measured by surveys and spreads on inflation-indexed bonds have been relatively stable, supported by the continued policy stimulus and expectations of a gradual pick-up in activity following improving business and consumer confidence as well as corporate earnings. More importantly, policy has been used proactively to support growth and prevent the possibility of a deflationary spiral. On balance, the market is expecting stronger recovery in the US economy in the second half-year, although this recovery is expected to be modest.

During the quarter, the real GDP growth in **UK** remained stable at 2.2% (4Q 2002: 2.2%) as the stronger government spending was offset by the slowdown in consumer spending. Latest trends indicate a modest growth prospect as higher business investment and government spending would be mitigated by weaker consumer spending, resulting from higher local and income taxes. Real GDP in **Germany** remained stable at 0.5% during the quarter where the broad-based improvement in domestic demand was weighed down by the decline in net exports. While the rise in domestic orders reported in March prompted optimism for further pick up in activity, continued weakness in consumer and business confidence arising from higher unemployment and declining corporate profitability may dampen growth prospects. The outlook for Germany has been revised downwards to 0.5% for 2003 (from 0.8%) as the strengthening of euro might also affect export growth. In Japan, the economy remained stagnant during the quarter. Increases in investment and consumption during the quarter was not able to offset the decline in export

growth. The outlook in the near term is for further deterioration in labour market conditions and declines in exports.

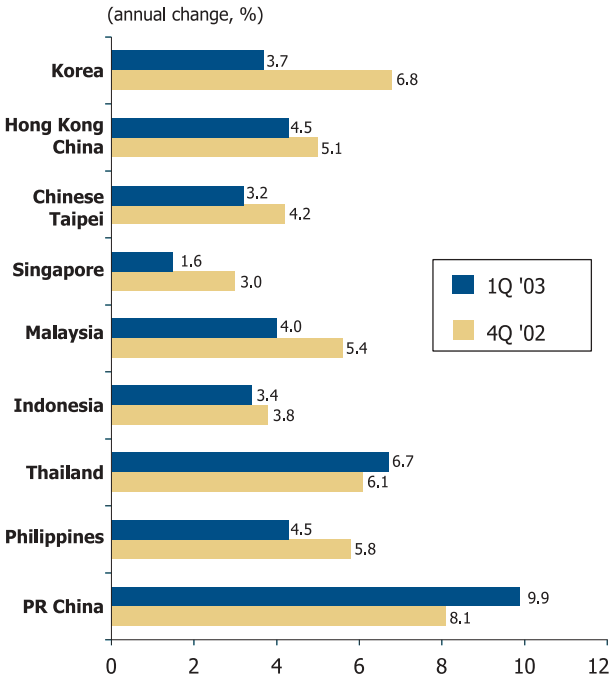
Regional Economies: Sustained growth despite increased uncertainties

In the regional economies, **economic growth** strengthened in the first quarter of 2003. Overall regional growth was sustained notwithstanding the negative impact of continued uncertainty due to geopolitical tensions as well as the impact of the Severe Acute Respiratory Syndrome (SARS) on consumer and business sentiments towards the end of the quarter. Growth continued to be supported by the resilience in exports and domestic demand. All regional countries, except the Philippines, recorded double-digit export growth rates. Amidst geopolitical risks in the Middle East, rising intra-regional trade, particularly for electronics and chemical products provided an impetus to export growth.

Real GDP of the **People's Republic of China** (P.R. China) expanded at a robust pace of 9.9%, the highest rate registered in six years. Growth was attributable mainly to strong export growth, favourable domestic demand conditions, fixed asset investment spending arising from continued government stimulus and expansion in foreign direct investment. In Hong Kong China, the economy grew by 4.5% due mainly to sustained intra-regional trade, particularly with P.R.China and Chinese Taipei. In **Korea**, growth moderated to 3.7%, given a slowdown in domestic demand reflecting mainly the concerns over geopolitical uncertainties. The **Chinese Taipei** economy continued to expand, albeit at a more moderate pace of 3.2%, supported by an expansion in exports which more than offset weak domestic demand conditions.

During the quarter, growth in the **Singapore** economy of 1.6% was attributable to an expansion in the manufacturing, wholesale and retail trade and transport and communications sectors. In **Indonesia**, real GDP rose by 3.4%, supported by robust domestic demand, with government consumption recording the largest increase. The growth was broad-based, with expansion registered across all sectors of the economy. In the Philippines, real GDP growth of 4.5% was due to broad-based expansion, led by the services sector.

Regional Economies: GDP Growth



Following the impact of SARS on the travel, tourism and related sectors, regional governments announced economic relief packages to mitigate its impact on the regional economies.

During the first quarter, the **inflation** environment of the **regional countries** remained

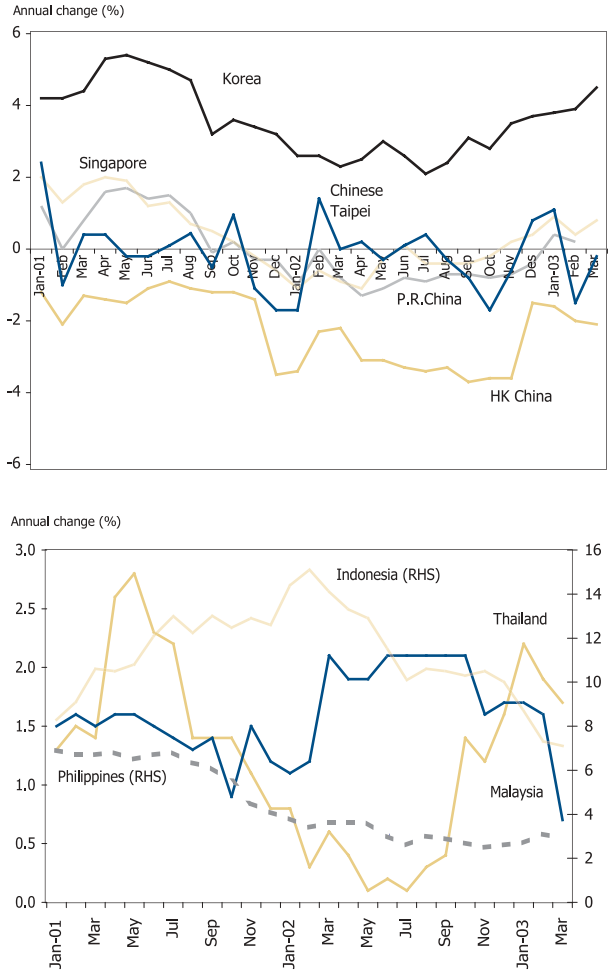
Economic Relief Packages to Mitigate the Impact from SARS outbreak

Singapore	17 April: A S$230 million (US$129.3 million) relief package (0.2% of GDP) focused on providing immediate relief to the most directly and adversely affected sectors, namely, the tourism and transport-related sectors. Allocations/concessions to the tourism and transport-related sectors accounted for 67% and 32% of the economic package. Key measures include tax rebates/reductions, interest rate subsidy, expenditure for training grants and fee rebates/waivers.
P.R. China	20 April - 12 May: Funds amounting to about 6.3 billion yuan (US$763 million) was targeted at improving the public health infrastructure, particularly in SARS-affected regions. Other measures taken by both the central and local governments include waivers/reductions of several tax rates and administrative fees for SARS-affected industries. Tax breaks in Guangdong, amounting to 900 million yuan (US$109 million) is expected to be effective in August 2003.
Hong Kong China	23 April: A HK$11.8 billion (US$1.5 billion) economic package (1% of GDP) will be funded by Hong Kong's fiscal reserves (currently at more than HK$320 billion). Key measures include government guarantee for loans, waivers on utility charges and license fees, reduction in public housing rentals, rebates to taxpayers, creation of temporary jobs and allocations for medical research and publicity campaigns.
ASEAN-China	29 April: ASEAN and China set up a Special SARS Fund at a meeting on SARS in Bangkok. The fund for SARS research and study was launched with Thailand's pledge of 10 million baht (US$0.23 million), 10 million yuan (US$1.2 million) from China and US$0.1 million from Cambodia.
Chinese Taipei	2 May: A T$50 billion (US$1.4 billion) special fund to help industries affected by SARS was approved.
Malaysia	21 May: A RM7.3 billion (US$1.9 billion) economic package (1.9% of GDP) focused on 90 steps to encourage private investment, strengthen competitiveness, generate new sources of growth, enhance the delivery system of both the public and private sectors and mitigate the impact of SARS. The package is expected to enable the economy to grow by more than 4.2%, which was achieved in 2002. Key measures include the reduction in the central bank's intervention rate, reduction in employee's contribution to the Employees' Provident Fund, provision of medical allowances, micro credit scheme, tax exemptions/reductions, relief guarantee facility, discount on bill payments, extension of pioneer status period and tax investment allowance, relaxation in foreign equity ownership, funds for training and subsidy on housing loan interest payment.

benign despite price increases registered in Korea, the Philippines and Thailand, particularly for energy and food products. In contrast, given a stronger rupiah, lower food prices led to the further moderation in consumer prices in Indonesia. Meanwhile, deflationary pressures in the Newly

Industrialised Economies (NIEs) (excluding Korea) and China showed signs of easing. In particular, prices in the People's Republic of China turned around to record the first positive increase since 3Q 2001, attributable mainly to the government's expansionary fiscal and monetary policies.

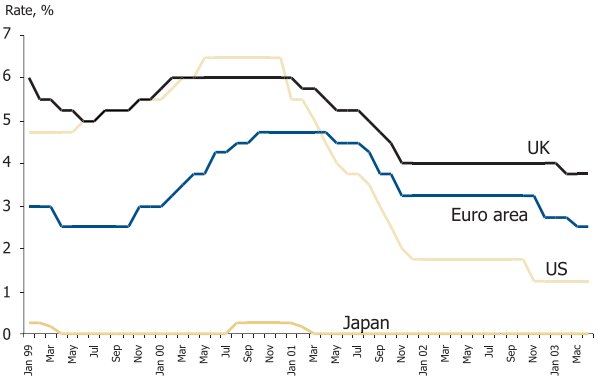
Regional Economies : Inflation rate



Monetary Policy in the Global Economy

Amidst a subdued global growth outlook and declining underlying inflation risks, several central banks in the industrial countries have reduced policy rates in recent months. In February 2003, the Bank of England (BoE) reduced its base lending rate by 25 basis points on concerns that the global outlook would be weak and that underlying domestic demand was weaker than expected. Subsequently, in March 2003, the European Central Bank (ECB) reduced interest rates by 25 basis points to 2.5% following expectations of a less optimistic growth outlook for the euro area. Despite policy rates remaining unchanged in the latest US Federal Reserve Board's policy meeting on 6 May, the concern on increased disinflation may have future implications on monetary policy actions.

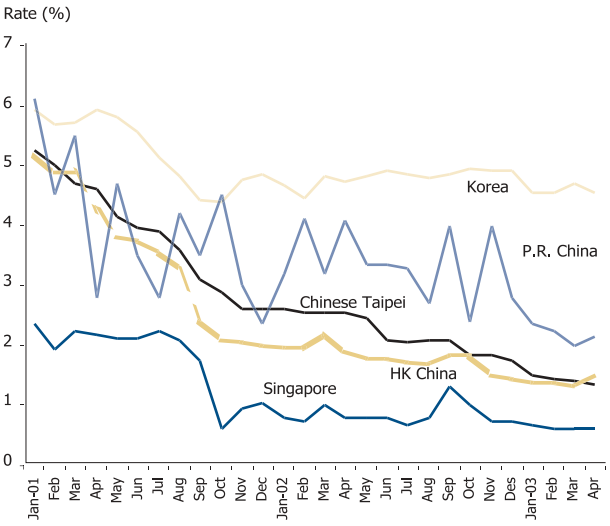
Major Industrial Countries: Interest Rate Movements

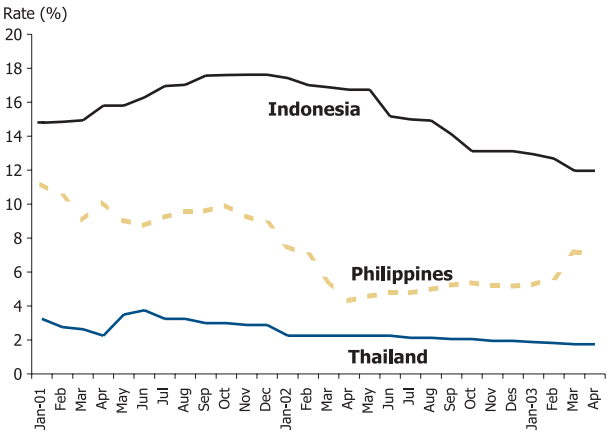


During the quarter, with the exception of Indonesia and the Philippines, **short-term interest rates** in the **regional countries** remained low, reflecting a soft global interest rate environment and excess liquidity conditions in domestic financial markets. However, in Indonesia, the downtrend in the 3-month rate since 1Q 2002 continued into 1Q 2003, prompted by the reduction in the policy rate in November 2002.

In April, the movements of short-term rates were mixed, with lower rates registered in the Philippines, Korea and Chinese Taipei, and stable rates in Indonesia, Thailand and Singapore. In Hong

Regional Countries : Interest Rate Movements





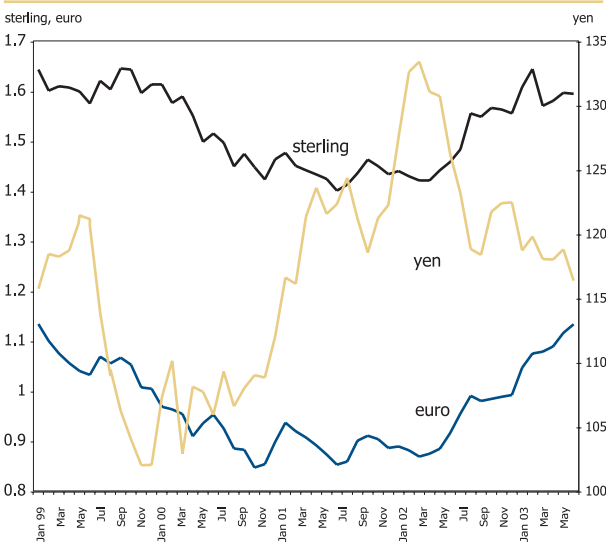
Kong China and P.R. China, the respective rates recorded increases.

Following a 25 basis point reduction in the rupiah overnight intervention rate on 1 and 9 May, respectively, the central bank in Indonesia reduced the rate to 10.5% on 29 May and further by another 25 basis points to 10.25% on 5 June. In line with a progressive easing stance and given subsiding inflationary pressures, rates have been gradually guided lower from the 15.1% peak reached in mid-2002. The interest rate cuts were aimed at stimulating domestic demand, reducing interest rate differentials and easing high debt servicing costs. Indications are that interest rates could fall below 10% during the year, given excess liquidity in the banking system. On 13 May, the central bank in Korea cut its overnight call rate target by 25 basis points to 4%, citing a contraction in production and accumulation in inventories amidst sluggish domestic demand. The emergence of negative sentiments also emanated from concerns over North Korea's nuclear programme and the spread of SARS in the Asian region.

Exchange Rate Developments

The **United States dollar** showed mixed trends against the other major currencies in the first quarter of 2003. The dollar depreciated against the euro by 5.6%, but appreciated marginally against the pound sterling and Japanese yen by 0.8% and 0.9% respectively. Gains in the euro were spurred by its favourable yield-differentials relative to dollar and yen assets as well as market expectations for the further strengthening of the euro. The pause in dollar depreciation during the Iraq war proved to be

Movements in the Major Currencies

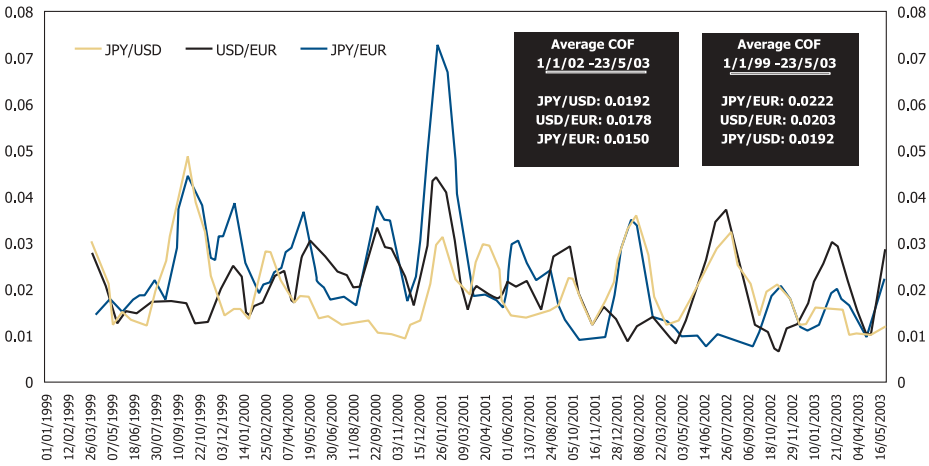


White Box: Volatility of the G-3 currencies

To analyse the relative volatility of the G-3 currencies, a comparison is made between the bilateral exchange rates of the three currencies, i.e. the USD, euro and yen. Using the coefficient of variation for the G-3 exchange rates for the period 1 January 2002 to 23 May 2003 (which roughly corresponds to the recent period of US dollar weakness), it is observed that, on average, currency pairs involving the USD have been more volatile than currency pairs involving the euro. However, expanding the sample to the period since the inception of the euro in January 1999, the currency pairs involving the euro are found to be on average more volatile than currency pairs involving the US dollar.

3-Month Rolling Coefficient of Variation for the G-3 Currencies

(1 Jan. 1999 - 23 May 2003)

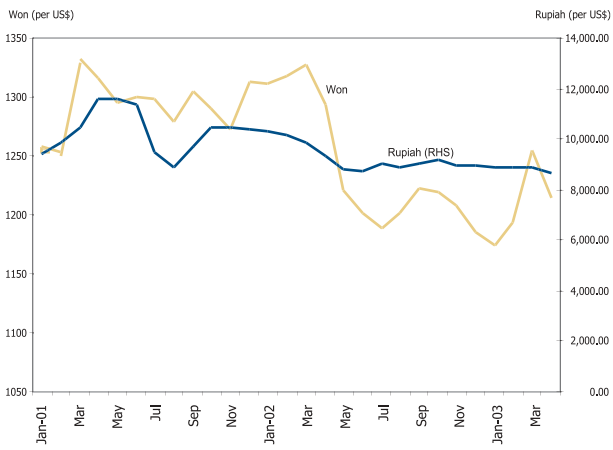


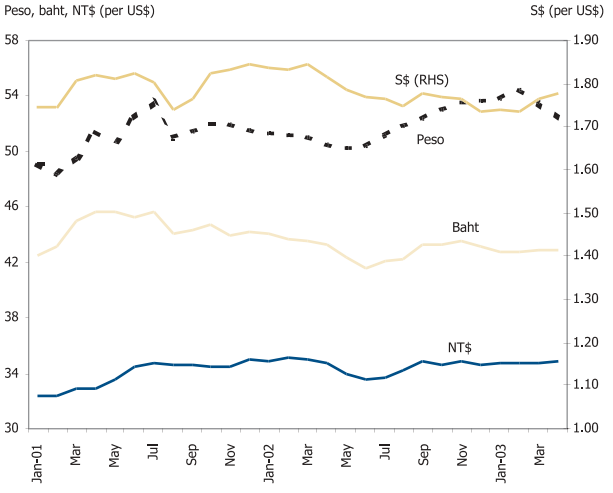
short-lived as the euro resumed its appreciating trend with the cessation of the Iraq conflict in April. The euro breached the E1 =US$1.17 level on 19 May 2003, approaching its launch level in January 1999 of E1 =US$1.1747, representing a gain of about 12% this year to date. Market perceptions that the US authorities have effectively abandoned its strong dollar policy, further fueled the euro's rise. Fund flows thus far were mainly from Japan to the euro-zone, resulting in a corresponding large decline in the euro-yen cross-rate. Against the US dollar, the yen has not shown a corresponding appreciation as market indications and authorities' statements indicate that intervention has been undertaken with the desire to prevent a sharp rise in the currency.

In the first quarter, regional currencies closed mixed against the US dollar. The downward movements in the Korean won, Singapore dollar and New Taiwan dollar were due mainly to weak investor sentiments, given concerns over the war in Iraq as well as the spread of the SARS illness towards the end of the first quarter. On the other hand, the appreciation in the Thai baht, Indonesian rupiah and the Philippine peso was buoyed primarily by positive domestic developments.

In April, the performance of regional currencies remained mixed against the US dollar. Whilst the positive sentiments on the Korean won and the Philippine peso were attributable mainly to falling global oil prices, the Indonesian rupiah appreciated from favourable economic data and the inflow of funds aimed at domestic assets. In contrast, the Thai baht, New Taiwan dollar and Singapore dollar depreciated on concerns over the negative impact of SARS on the economies.

Movements in the Regional Currencies





DEVELOPMENTS IN THE MALAYSIAN ECONOMY

Domestic demand was sustained in the first quarter of 2003

The first quarter GDP growth continued to be mainly supported by the expansion in domestic aggregate demand. Consumption growth was sustained at 6.2% while gross fixed capital formation expanded by 3.8%. Underpinned by

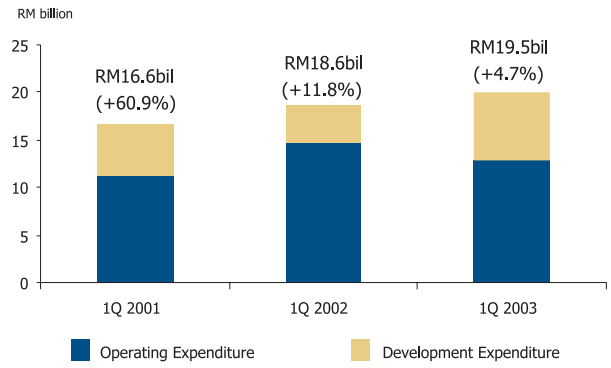
GDP by Expenditure Components (at constant 1987 prices)

	2002			2003
	Q1	Q4	Year	Q1
	Annual change in %			
Aggregate Domestic Demand (excluding stocks)	0.0	6.6	4.2	5.4
Consumption	4.6	5.1	6.2	6.2
Private sector	*3.3*	*4.6*	*4.4*	*4.2*
Public sector	*11.4*	*6.5*	*12.2*	*15.6*
Gross Fixed Capital Formation	-8.5	10.0	0.3	3.8
Exports of Goods and Services	-6.5	7.2	3.6	1.9
Imports of Goods and Services	-4.8	8.1	6.2	1.7
GDP	**1.3**	**5.4**	**4.1**	**4.0**

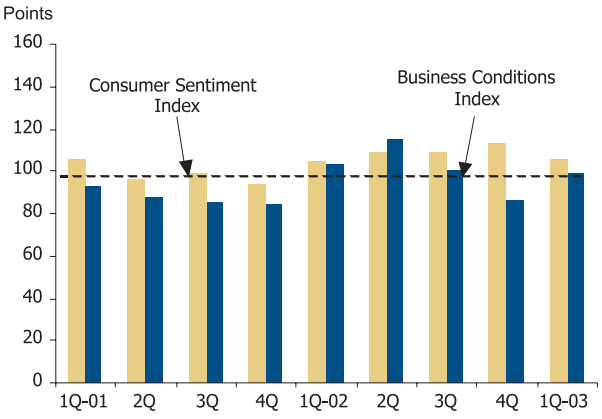
stronger public sector spending, **public consumption** increased by 15.6%, due mainly to higher expenditures on emoluments, and supplies and services. At the same time, **private consumption** continued to be resilient, supported by low inflation, stable job market as well as higher commodity prices. In addition, various promotions by retailers nationwide also promoted consumer spending. This was reflected in major consumption indicators such as imports of consumption goods, loans disbursed for purchases of consumption goods and services and consumer spending via credit cards. For the first quarter, the Malaysian Institute of Economic Research (MIER) Consumer Sentiments Index remained above the threshold level of 100-

points, indicating that consumers were generally positive on the outlook for the domestic economy. Notably, the survey showed that housing demand in the coming months remained favourable as consumers were taking advantage of low interest rates.

Higher Federal Government expenditure



Consumers were generally optimistic while business confidence continued to be resilient



The positive growth in **gross fixed capital formation** continued into the first quarter of 2003 (3.8%, 4Q 2002: 10%), due mainly to higher investment by the public sector. Development expenditure of the Federal Government was increased on education, health and infrastructure development. Meanwhile, the first quarter Business Conditions Index from the MIER was higher by 13.2 points compared to the fourth quarter of 2002 (99.3 points, 4Q 2002: 86.1 points), indicating better results in most components that make up the index, including production, domestic orders, investment in plant and equipment, expected production, export orders and expected export sales. In addition, positive growth in sales of commercial vehicles and loans disbursed for the manufacturing sector also pointed to continued investment activities during the quarter.

Sectoral Developments

Sustained growth in the manufacturing sector

Value added in the **manufacturing sector** expanded by 5.2% compared with the decline in the first quarter of 2002 (4Q 2002: 5.7%). The expansion was supported by stronger growth in the

Performance in the Manufacturing Sector

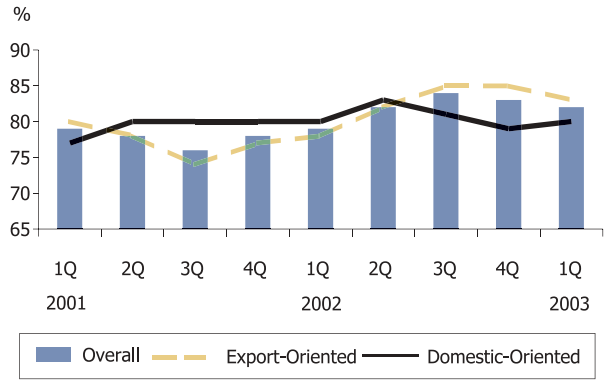
	2002			2003
	1Q	4Q	Year	1Q
	Annual Change in %			
Value Added (Constant Price)	**-2.3**	**5.7**	**4.0**	**5.2**
Overall Production	**-3.4**	**6.7**	**4.5**	**6.3** [2/]
Export-oriented industries	**-5.5**	**8.9**	**5.0**	**7.0**
of which:				
- Electronics	-0.8	12.5	13.4	8.1
- Electrical	-9.3	-4.2	-5.1	-5.5
- Textiles & wearing apparel	-14.9	4.4	-6.2	-0.6
- Chemicals and chemical products	-8.8	13.1	2.7	14.2
- Off-estate processing	1.0	12.0	7.1	4.4
- Rubber products	-4.5	5.5	2.0	9.1
- Wood and wood products [1/]	-15.4	1.0	-6.0	3.5
Domestic-oriented industries	**3.5**	**0.6**	**3.4**	**4.6**
of which:				
- Transport equipment	18.0	-7.9	6.2	-6.3
- Fabricated metal products	-4.9	-1.9	0.8	1.3
- Iron & steel and non-ferrous metal	-3.3	4.7	2.4	12.8
- Non-metallic mineral products	8.0	1.3	5.1	8.1
- Petroleum products	3.4	-6.0	-4.1	1.9
- Food	12.4	10.3	8.7	3.2
Total Manufactured Exports	**-4.0**	**5.2**	**4.8**	**1.7**
- Electronics	1.1	4.6	10.6	-6.1
Semiconductor	-13.2	36.7	19.9	27.1
Electronic equip. & parts	13.8	-18.0	3.5	-28.6
- Electrical products	-13.9	-8.5	-9.8	-6.5
Consumer electrical products	-11.7	-9.5	-10.6	-11.8
Industrial & commercial electrical prod.	-18.8	-20.5	-17.0	-12.5
Electrical industrial machinery & equip.	-10.4	11.9	2.3	4.0
Household electrical appliances	7.0	81.8	26.1	78.3
- Wood and wood products	-12.6	19.2	4.9	13.2
- Furniture & parts	3.2	7.5	7.7	8.8
- Textiles, clothing & footwear	-17.0	5.3	-5.2	8.3
- Optical & scientific equipment	5.6	4.8	4.6	19.2
- Chemicals and chemical products	-6.1	34.6	16.2	33.5
- Petroleum products	-35.6	29.7	-9.0	67.3

[1/] Output of furniture and parts are not captured in the wood production data.
[2/] Manufacturing production index for 1Q 2003 was subsequently revised to 7.6%.

domestic-oriented industries and continued expansion in the export-oriented industries. This resulted in the overall capacity utilisation rate in the manufacturing sector remaining at a high level of 82% (4Q 2002: 83%), with the export- and domestic-oriented industries operating at 83% and 80% respectively (4Q 2002: 85% and 79% respectively). While output growth remained strong, exports of manufactured goods moderated to 1.7% (4Q 2002: 5.2%) due mainly to lower exports of electronic equipment and parts and electrical goods. However, this was offset to some extent by the strong increase in exports of chemicals, petroleum products, textiles, manufactures of metal, optical and scientific equipment and food products. The weaker performance of the manufacturing exports was also due to continued decline in export prices, while export volume grew at a relatively stable rate.

Output growth in the **export-oriented industries** was driven largely by strong expansion in the chemical and semiconductor industries. In particular, both the production and exports of chemicals and chemical products expanded strongly, benefiting from the expansion in the electronics sector and higher external demand for organic chemicals and plastics, particularly from the Asia-Pacific region. Growth was also supported by strong expansion in output of the pharmaceutical products industry, following higher demand from Singapore and from the domestic market. The semiconductor industry also continued to perform well. Output was driven largely by strong global demand, particularly from Asia and Europe. Growth was driven by the wireless sector and, to some extent, the consumer sector (e.g. DVDs, digital cameras and video games). As a result, the semiconductor segment of the overall electronic exports continued to register strong growth, similar with trends in the other regional economies.

Capacity Utilisation in the Manufacturing Sector



Exports of electronics as a group, however, declined as the positive effect from the semiconductor segment was muted by lower exports of computers and peripherals arising from strong competition from lower cost producing countries. Similarly, both production and exports of electrical products such as audio-visual and air-conditioners was affected by increased competition from these countries which led to declines in prices of the electronics and electrical products. Growth in the export-oriented industries was also supported by higher output of rubber products arising from increased demand for rubber gloves from the Middle East, following the outbreak of the war in Iraq.

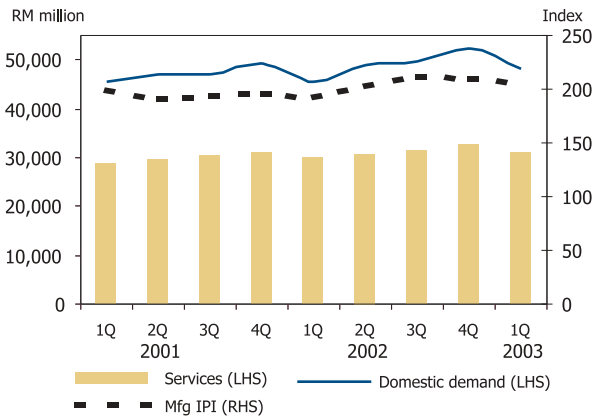
Growth in the **domestic-oriented industries** strengthened due to higher expansion in output of the iron and steel industry arising from higher domestic and external demand. Exports of iron and steel have been strong due to more favourable prices in the export market. Growth in the paper and paper products industry also expanded during the quarter due to increased external demand for paper and paperboard. Meanwhile, production of transport equipment continued to remain subdued in view of the softening in demand for passenger cars as well as

some build-up in inventories from the previous year.

Services sector supported by domestic demand and trade-related activities

The **services sector** continued to expand by 4% in the first quarter of 2003 (4Q 2002: 4.6%). As the outbreak of SARS occurred towards the end of the quarter, its impact was not seen in the first quarter. Domestic demand and strong growth in trade-related activities in line with the expansion in exports continued to support growth in the sector. Tourist arrivals remained high in the first two months of the year despite continued geopolitical tensions. Arrivals only declined in late March into April as travellers became more cautious with the issuance of the World Health Organisation (WHO) travel advisory in mid-March to several countries in the region and Canada. Despite the slowdown in inbound tourists, the wholesale, retail trade, hotels and restaurants sub-sector recorded a stronger growth supported mainly by domestic demand. Similarly, the transport, storage and communication sub-sector strengthened due to robust expansion in the telecommunication industry, in particular the cellular segment, supported by rapid growth in mobile data applications. The growth in the telecommunication industry was further augmented by continued increase in the Internet segment due to rise in subscribers. In the transport sector, strong port activities, including the rapid growth in transhipment cargo in the major ports, had partly offset the effects from weaker air travel.

Services sector supported by domestic demand and trade-related services



Performance in the Services Sector (Value Added)

	2002			2003
	1Q	4Q	Year	1Q
	Annual change in %			
Intermediate Services	**6.0**	**3.8**	**4.3**	**3.7**
Transport, storage & communication	2.0	3.3	2.6	4.2
Finance, insurance, real estate & business services	8.4	4.0	5.3	3.5
Final Services	**3.6**	**5.2**	**4.1**	**4.1**
Electricity, gas & water	4.0	4.3	3.9	6.2
Wholesale & retail trade, hotel & restaurants	1.9	2.6	2.6	3.6
Government services	7.0	9.3	6.7	1.8
Other services	3.6	6.9	4.6	6.2
Total Services	**4.5**	**4.6**	**4.1**	**4.0**

In the finance sector, narrow interest margins amidst the continued strong competition for lending was reflected in more moderate growth in the sub-sector. Overall, the finance, insurance, real estate and business services sector continued to receive support from the insurance industry, which recorded double-digit growth in premium collections. Growth in the utilities sub-sector was higher during the first quarter, reflecting strong demand for electricity from the industrial, commercial and household sectors.

Higher construction activity supported by public projects

The **construction sector** recorded a growth of 1.2% in the first quarter of 2003 (4Q

2002: 0.5%), supported by higher construction activity on public sector projects, including construction of roads, schools, public housing and health facilities. Construction activity in the residential sub-sector was sustained, following the large increase in launches in 2002. Activities in the non-residential sub-sector remained subdued amidst the overhang in office and retail space. Loans disbursed for purchase of residential property increased by 4.6% in the first quarter of 2003 (2002: 4.2%) as purchasers took advantage of the low cost of financing.

While the return of foreign workers helped to support construction activity during the quarter, growth was hampered by delays in some projects following a temporary shortage of steel bars. The shortage arose following the announcement that price control on steel bars and cement would be liberalised. However, domestic production of iron and steel had remained strong during the first quarter, increasing by 12.4%. The shortage situation has improved since as steps have been taken to enhance the efficiency of the distribution channels.

Construction Indicators

Indicator	2002 1Q	2002 4Q	2003 1Q
New sales and advertising permits (number)	274	242	207
(annual change, %)	20.2	-11.4	-24.5
Housing approvals (number)	48,895	45,610	33,899
(annual change, %)	11.4	-32.3	-30.7
Production of construction-related products (annual change, %)	2.6	2.8	10.2 [1/]
Loans approved for construction (annual change, %)	-10.2	69.6	19.4
Imports of construction materials & mineral products (annual change, %)	-5.8	9.9	3.6

[1/] Production of construction related materials for the 1Q 2003 was subsequently revised to 13%.
Source: Ministry of Housing and Local Government and Department of Statistics, Malaysia

Performance of the Agriculture Sector

	2002 1Q	2002 4Q	2002 Year	2003 1Q
	Annual change in %			
Value Added (RM million at 1987 prices)	**-3.6**	**5.5**	**3.0**	**3.6**
Production [1/]				
Of which:				
Crude palm oil	-8.4	1.6	0.9	0.5
Crude palm kernel oil	-4.8	0.9	-3.9	-5.2
Rubber	1.2	17.8	7.7	16.6
Saw logs	-7.5	18.5	4.2	0.1
Cocoa	-37.2	35.2	-17.4	79.4
Exports (RM million)	**7.0**	**49.3**	**31.9**	**41.8**
Of which:				
Palm oil				
('000 tonnes)	-11.8	12.1	3.8	9.3
(RM/tonne)	41.0	46.9	44.7	41.4
(RM million)	24.4	64.7	50.2	54.6
Palm kernel oil				
('000 tonnes)	54.1	15.1	5.9	-33.9
(RM/tonne)	1.4	38.9	25.6	51.0
(RM million)	56.3	59.8	33.0	-0.2
Rubber				
('000 tonnes)	-10.5	8.2	12.9	13.4
(Sen/kg)	-11.6	55.1	17.0	57.6
(RM million)	-21.0	67.9	32.1	78.7
Saw logs				
('000 cu. metres)	-7.5	12.9	0.8	19.5
(RM/cu. metre)	-10.2	31.8	16.6	18.9
(RM million)	-17.0	48.8	17.5	42.1
Cocoa beans				
('000 tonnes)	21.3	71.2	29.6	51.7
(RM/tonne)	37.0	70.3	49.5	62.9
(RM million)	66.1	191.5	93.7	147.2

[1/] In '000 tonnes, except for saw logs in '000 cubic metres

The agriculture sector continued to perform favourably

The **agriculture sector** expanded by 3.6% (Q4 2002: 5.5%) despite a marginal growth in the output of crude palm oil (0.5%; 1.6% in Q4 2002). Growth was supported mainly by higher production of other major commodities namely rubber and cocoa as well as selected crops within the other agriculture sub-sector. Favourable prices as well as strong external demand encouraged increased production of these commodities. During the

quarter, prices of major commodities, namely crude palm oil, rubber and cocoa, were higher by 37.7%, 51.3% and 55.5% respectively to RM1,585 per tonne, 364 sen per kilogramme and RM6,980 per tonne respectively. Higher prices, together with increased export volume of major commodities, including palm oil, rubber, saw logs and cocoa contributed to higher export proceeds of the agriculture sector by 41.8% during the quarter.

Production of **crude palm oil** increased marginally by 0.5% due to the lower yields as well as continued replanting activity. The lagged effects from the dry spell in the earlier months had affected yields with the average oil extraction rate of crude palm oil declining to 19.57% during the quarter (Q4 2002: 20.23%). Meanwhile, a total of 13,840 hectares of old oil palm areas were felled for replanting purposes during the quarter. Crude palm kernel oil production declined by 5.2% during the quarter also due to the lower yields.

In the case of **rubber**, although the first quarter is usually a seasonally low production period due to wintering, production in the first quarter of 2003 exceeded expectations rising by 16.6%. The sharp increase in production was, to a large extent, due to intensive tapping activity among smallholders (who account for 88% of total production) in response to the more attractive rubber prices. Since 2002, rubber prices have trended upwards to reach an annual increase of 81% in March 2003, driven mainly by favourable global demand, including strong demand for rubber gloves following the Iraqi war, while supply remained tight in the other major producing countries of Thailand and Indonesia. Growth in the agriculture sector during the quarter was also contributed by higher production of cocoa. Besides the higher price of cocoa that has motivated better agronomic practices among the smallholders, several yield improvement programmes have led to the expansion in cocoa output. These programmes included the on-going smallholders' rehabilitation scheme.

The developments such as the Iraq war and the outbreak of the SARS disease in the regional countries had a minimal impact on the overall performance of the agricultural sector. Although the war had briefly affected orders and disrupted palm oil shipments to the Middle East, the overall external demand for palm oil remained strong, as reflected by the sharp increase in export receipts of 54.6% during the quarter. Similarly, the impact of SARS on the agriculture sector was negligible, briefly affecting Malaysia's vegetable exports to Singapore.

Continued strong expansion in the mining sector

After the strong performance in the last two quarters of 2002 (7-8% growth), the **mining sector** expanded further by 3.8% in the first quarter of 2003. Growth emanated mainly from higher production of **natural gas** by 5.8%. There was a significant increase in new capacity following the commencement of several new gas fields since 2002 to accommodate increased demand from the newly operational MLNG Tiga plant in March and the power generation plants. The increased production in gas was also supported by higher external demand for LNG during the period, with Japan accounting for the bulk of the exports. Meanwhile, **crude oil** (including condensates) production grew by 2.8% to 726,630 barrels per day in response to increased demand, both domestic and abroad. In particular, demand from domestic petroleum refineries increased by 3.6%, while export volume grew by 4.2%. Higher demand were mainly from buyers in the Asian region.

Performance of the Mining Sector

	2002			2003
	1Q	4Q	Year	1Q
	Annual change in %			
Value Added (RM million at 1987 prices)	**1.4**	**7.1**	**3.7**	**3.8**
Production				
Of which:				
Crude oil and condensates ('000 barrels)	4.0	7.4	4.9	2.8
Natural gas (net) (million standard cubic feet)	-1.6	9.3	3.5	5.8
Exports (RM million)	**-29.4**	**29.3**	**-4.4**	**50.9**
Of which:				
Crude oil				
('000 tonnes)	-0.8	5.5	7.4	4.2
(US$/barrel)	-26.1	37.2	-2.9	61.3
(RM million)	-26.7	44.7	4.3	68.0
Liquefied natural gas				
('000 tonnes)	-3.3	12.9	-2.6	6.9
(RM/tonne)	-23.2	6.6	-8.3	28.8
(RM million)	-25.7	20.4	-10.7	37.8

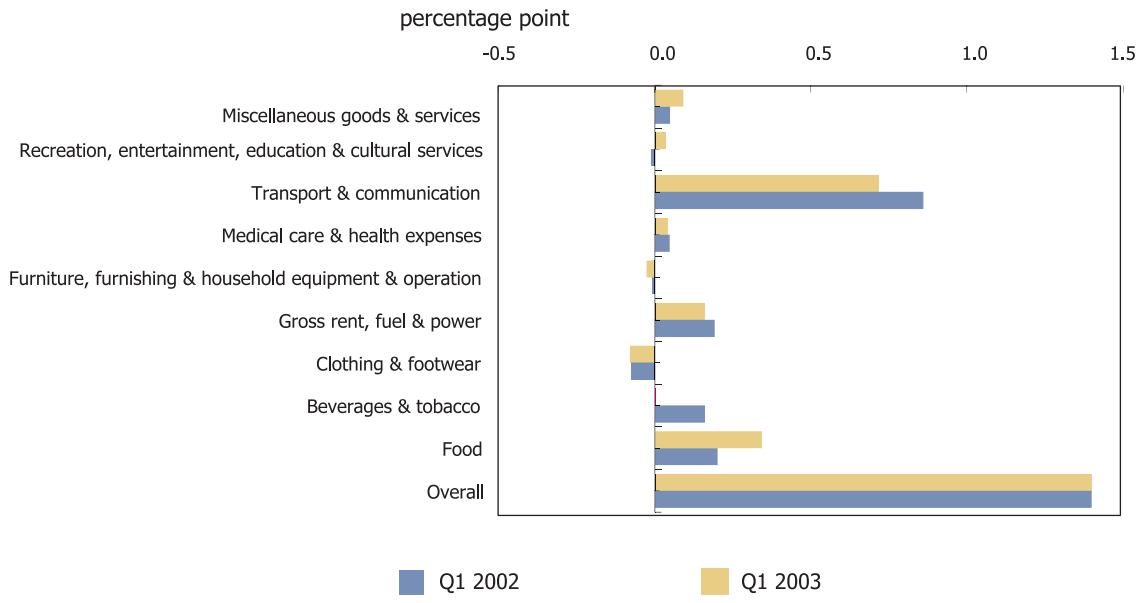
On the price front, the Malaysian crude oil price benefited from developments in the international oil markets during the quarter, with the export unit value for Malaysian crude oil averaging higher at US$32.63 per barrel, or an increase of 61.3% on a year-on-year basis. Reflecting continued strong growth in the external demand for crude oil and LNG and supported further by the sharp increases in prices, aggregate mineral exports rose sharply by 50.9% during the quarter.

Inflation remained low

Inflation, as measured by the annual change in the Consumer Price Index (CPI), remained low at 1.4% during the first quarter of 2003 (1Q 2002: 1.4%; 4Q 2002: 1.8%).

Food prices were higher compared with the first quarter of 2002, driven mainly by higher prices for food items taken at home. Prices for transport and communication as well as beverages and tobacco, on the other hand, registered slower increases, mainly on account of the lapse of the impact of increases in retail petrol prices and sales

Contribution to Inflation



tax on tobacco products. The price increases were implemented in October 2001.

The annual increase in CPI averaged 1.6% in the first two months of 2003 but moderated to 0.7% in March. This was due to the lapse of the impact of the higher tariff on telephone services implemented in March 2002.

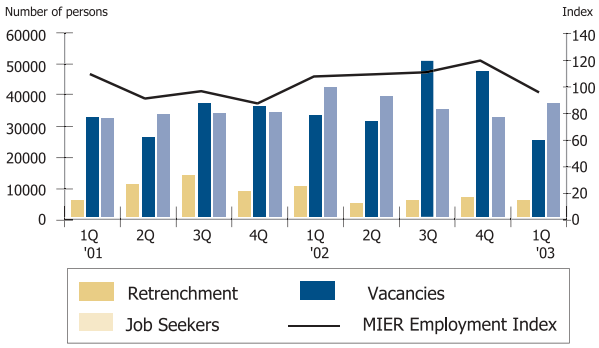
Stable labour market conditions

In the first quarter of 2003, the overall labour market conditions remained stable. During the quarter, workers retrenched were considerably lower than the preceding and corresponding quarters of 2002 by 13% and 46% respectively. At the same time, an additional 16,859 workers were affected by less severe cost-cutting measures adopted by employers that included temporary layoffs, pay cuts and voluntary separation schemes. The workers impacted by these measures were also significantly lower than the preceding and corresponding quarters of 2002 by 39% and 46% respectively as the slowdown in demand for products was viewed as transitory and cyclical in nature.

The impact of the uncertainties surrounding the global economic outlook on the domestic economy was reflected by registered job vacancies (25,052) which was lower than registered job seekers (36,946) causing the ratio of vacancies to job seekers widening to 1:1.5 at the end of March 2003 from 1:1.3 and 1:0.6 at the end of March and December 2002 respectively.

Labour productivity improved during the quarter. Data from the Monthly Survey of Manufacturing Industries undertaken by the Department of Statistics showed that labour productivity as measured by the real sales value of products per employee increased further by 9.4% (4Q 2002: 6.0%). Real wage per employee also increased by 3.1% (4Q 2002: 2.0%).

Labour Market Conditions



External sector characterised by strong trade surplus and rising external reserves

The trade surplus was larger at RM17.6 billion in the first quarter (4Q2002: RM14.8 billion), the largest since the first quarter of 2000.

Gross exports expanded by 7.8% supported by exports of manufactured goods, agriculture and minerals. The slower rate of growth in manufactured exports of 1.7% was attributed mainly to lower exports of electronic equipment and parts and electrical goods amidst increased competition from lower cost producing countries. This resulted in declines in export volume and prices of electrical goods. Meanwhile, semiconductor exports continued to register robust growth in line with similar trends in the other regional economies. Global demand for semiconductors remained strong, particularly in the Asia-Pacific region. Other major manufactured goods exports, namely chemicals, petroleum products, textiles, manufactures of metal, optical and scientific equipment and food products,

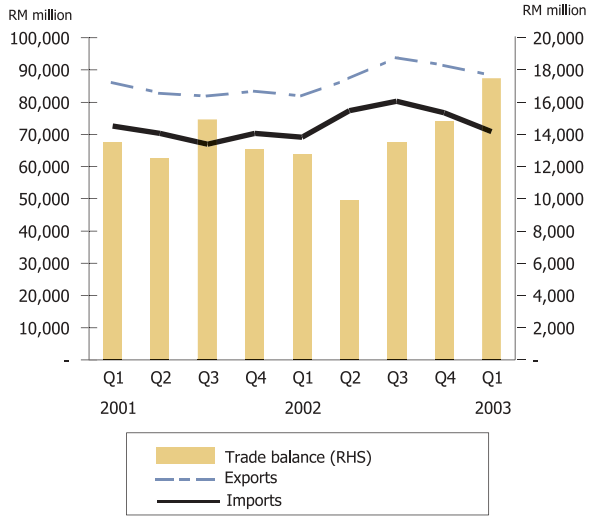
continued to expand strongly. Overall, the volume of manufactured exports grew by 7.5%, while export prices in the sector declined by 3.3% (7.5% and -1.3% respectively in fourth quarter of 2002).

Export earnings from agriculture increased by 41.8%. Exports of palm oil remained strong during the quarter, increasing by 54.6%, attributable to higher export prices and volume. Export prices of palm oil averaged higher at RM1,658 per tonne amidst the tight global supplies of vegetable oils. Overall, export volume of palm oil remained favorable despite a brief disruption in shipments to the Middle East market following the outbreak of the war in late March. Demand, particularly from major buyers, namely, China, European Union and India, grew strongly by 17 - 35%.

Export earnings from minerals rose by 50.9%, attributable to higher proceeds from crude oil and LNG. During the quarter, export prices of Malaysian crude oil strengthened to US$32.63 per barrel (4Q 2002: US$28.03), reflecting primarily developments in the global oil markets. Factors include the price premium related to the war risks, low inventories in the United States and supply disruptions in a few major producing countries. Export prices of LNG were also higher during the quarter in tandem with the trend in oil prices. Overall, the strong performance of mineral exports during the quarter was driven by both increases in volume and prices.

The diversification of export markets has improved since the third quarter of 2002. The diversification of markets is measured by the

Trade Balance

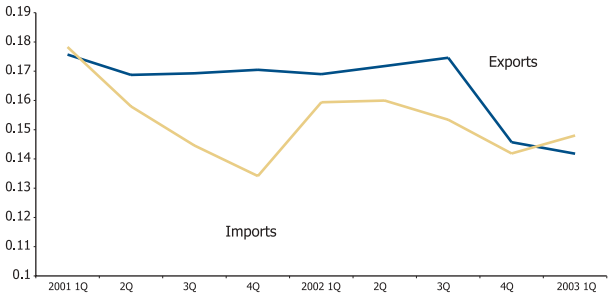


Trade Account

	2002			2003
	1Q	4Q	Year	1Q
	Annual change in %			
Gross Exports	**-4.9**	**9.7**	**6.0**	**7.8**
Manufacturing	-4.0	5.2	4.8	1.7
Agriculture	7.0	49.3	31.9	41.8
Minerals	-29.4	29.3	-4.4	50.9
Gross imports	**-4.8**	**9.0**	**8.3**	**2.3**
Capital goods	-9.9	6.6	10.6	-5.0
Intermediate goods	-5.8	7.0	6.2	2.5
Consumption goods	6.7	22.1	15.9	4.7
Trade balance (RM bn)	**12.8**	**14.8**	**51.0**	**17.6**

Source: Department of Statistics, Malaysia

Diversification Index



The export / import diversification index is a modified version of Herfindahl-Hirschman index. It is normalized to obtain a numeric range from 0 to 1. A lower index signifies a higher degree of diversification.

normalized Herfindahl-Hirschman index where a ratio closer to zero reflects increasing diversification. The index was constructed for 32 of Malaysia's major trading partners which account for 93% of total exports. Reflecting the increasing diversification in export markets, the index declined from 0.17 in the third quarter of 2002 to 0.14 in the first quarter of 2003.

Exports to regional countries (excluding Japan) which accounted for 45.4% of Malaysia's exports, continued to grow by 14% (4Q2002: 18.4%). The impetus to this growth stemmed from the continued strong export growth of 24.3% and 41.3% to the People's Republic of China and Hong Kong China respectively. Exports to Japan and the European Union, which accounted for a share of 11.8% and 13%, continued to grow by 3.2% and 7% respectively. However, exports to the United States recorded a decline of 12.8% reflecting the lower exports of electrical and electronic products, particularly parts and accessories of computers. Nevertheless, exports of optical and scientific instruments, rubber products and chemicals to the United States continued to increase.

Real effective **exchange rate of the ringgit** has depreciated since June 2002. This provided further support to the expansion in exports as reflected in the strong volume growth of commodities and manufactured exports, which grew in the range of 5% to 27% and 9% to 29% respectively. The dip in the volume of commodity exports in November 2002 was due mainly to lower off-take of palm oil by major buyers in the EU, the Middle East and Pakistan, which built up stocks in

Malaysia: Direction of exports to the regional countries

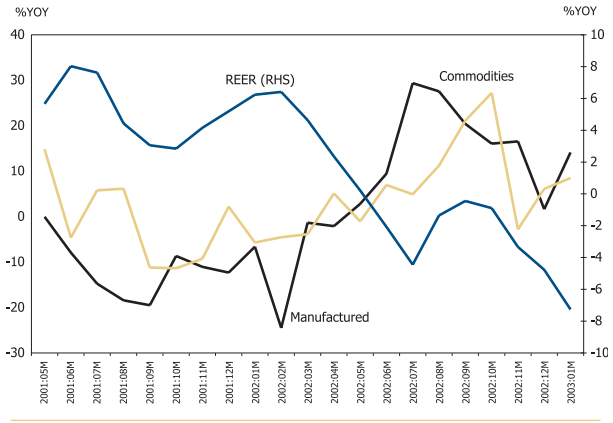
	2002		2003	2002		2003	2002		2003
	1Q	4Q	1Q	1Q	4Q	1Q	1Q	4Q	1Q
	RM million			% share of total exports			% annual change		
Singapore	14,064	15,335	14,766	17.2	16.8	16.7	-4.4	6.3	5.0
Thailand	3,631	3,842	4,066	4.4	4.2	4.6	4.9	35.8	12.0
Indonesia	1,568	1,715	1,836	1.9	1.9	2.1	18.8	5.2	17.1
Philippines	1,241	1,177	1,316	1.5	1.3	1.5	-2.4	-0.1	6.1
Brunei Darussalam	206	238	258	0.3	0.3	0.3	-16.1	-4.9	24.8
Vietnam	492	619	673	0.6	0.7	0.8	9.5	47.0	36.9
Selected ASEAN Countries	21,202	22,926	22,915	25.9	25.1	25.9	-1.2	10.5	8.1
People's Republic of China	4,191	5,633	5,208	5.1	6.2	5.9	24.8	34.4	24.3
Hong Kong China	4,002	6,150	5,657	4.9	6.7	6.4	12.0	56.2	41.3
Chinese Taipei	3,013	3,298	3,251	3.7	3.6	3.7	9.1	-8.4	7.9
South Korea	2,794	3,511	3,105	3.4	3.8	3.5	-12.1	34.8	11.1
Total	**35,202**	**41,518**	**40,136**	**43.0**	**45.4**	**45.4**	**2.5**	**18.4**	**14.0**

Source: Department of Statistics, Malaysia

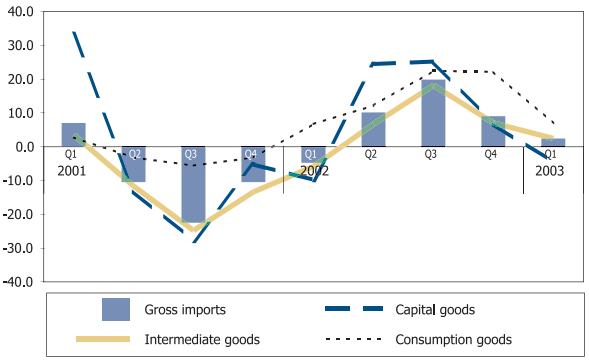
the preceding periods. The slowdown in the volume of manufactured exports in December 2002 was reflected the closure of ports on the west coast of the US. Subsequently, the volume picked up in January 2003.

In the first quarter, imports continued to grow, albeit at a slower rate of 2.3%, reflecting

Real Effective Exchange Rate (REER) & Export Volume



Import growth



mainly the moderate expansion in imports of intermediate goods (2.5%). The moderation in intermediate imports, which accounted for 72.6% of total imports, was due to the decline in imports of parts and accessories of capital goods used as inputs for the export-oriented electronics industry.

Changing structure of imports

The share of imports for domestic use has been increasing since 1998 from 14% to 18.2% of total imports in 2002. Imports for production for the domestic market grew by 9.7% in 2002 supported by the increase in imports of intermediate inputs namely, imports of parts and accessories of transport equipment and food and beverages for industry. Imports of consumer goods, especially durable goods, caused imports of consumption goods to increase by 15.9% in 2002.

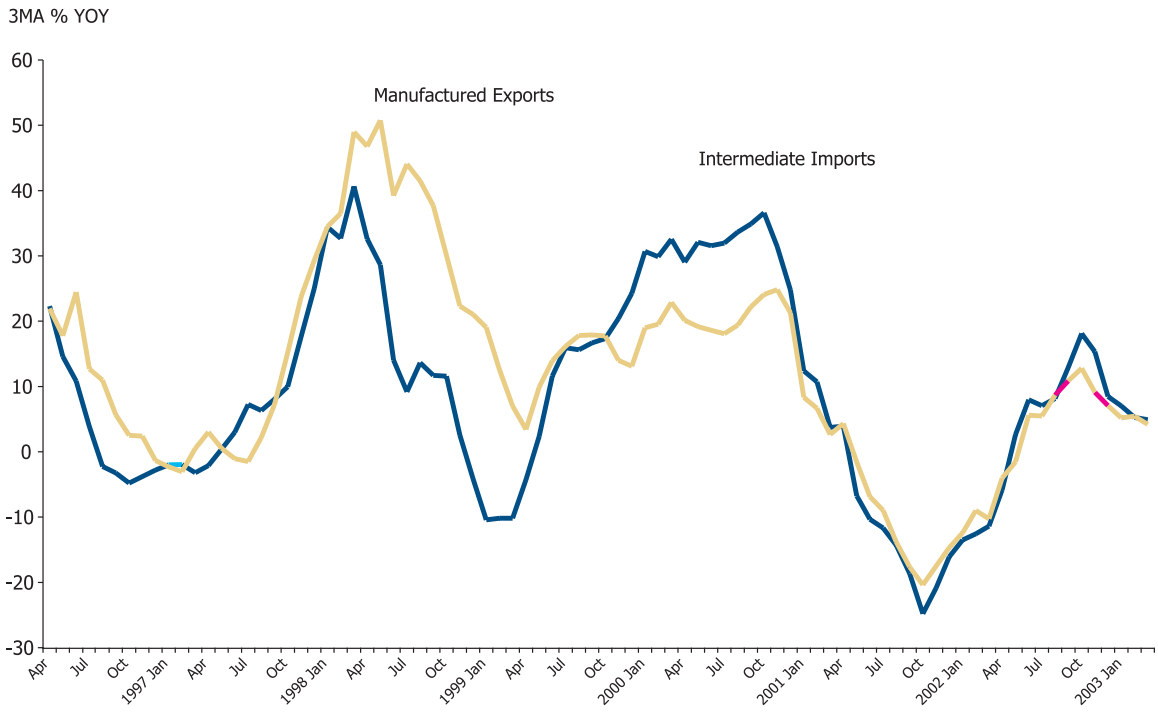
Malaysia: Imports For Domestic Use

	1995	1996	1997	1998	1999	2000	2001	2002
	% share of total imports							
1 Capital goods	**3.9**	**7.7**	**3.7**	**2.0**	**1.8**	**2.0**	**2.2**	**2.2**
Capital goods (except transport equipment)	3.2	6.1	2.8	1.9	1.6	1.7	1.8	1.8
Metal tools	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1
Metal containers	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Agricultural equipment (incl tractors)	0.1	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Construction and mining equipment	1.2	2.5	0.9	0.1	0.1	0.2	0.2	0.2
Generators, turbines and electric motors (incl transformers)	1.6	3.0	1.4	1.5	1.3	1.3	1.3	1.3
Refrigerators	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Air-conditioners	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0
Transport equipment, industrial	0.7	1.6	1.0	0.2	0.2	0.3	0.4	0.4
Commercial vehicles and buses	0.7	1.6	1.0	0.1	0.2	0.3	0.4	0.4
Trailers and containers	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2 Intermediate goods	**4.8**	**5.2**	**5.0**	**4.7**	**5.0**	**6.4**	**7.8**	**7.7**
Food and beverages, primary, mainly, for industry	0.7	0.7	0.7	0.8	0.8	0.6	0.7	0.8
Food and beverages, processed, mainly for industry	0.8	0.8	0.8	1.0	0.8	0.6	0.9	0.9
Fuel and lubricants, primary	0.3	0.4	0.4	0.5	0.7	1.7	2.3	1.8
Fuel and lubricants, processed	1.3	1.5	1.6	1.6	1.6	2.2	1.8	1.9
Parts and accessories of transport equipment	1.7	1.8	1.5	0.9	1.1	1.3	2.0	2.4
3 Consumption goods	**6.2**	**6.4**	**6.3**	**5.6**	**6.0**	**5.5**	**5.9**	**6.3**
Food and beverages, primary, mainly, for household consumption	0.8	0.8	0.8	0.8	0.8	0.7	0.9	0.8
Food and beverages, processed, mainly for household consumption	1.4	1.7	1.7	1.7	1.6	1.4	1.7	1.6
Transport equipment, non-industrial	0.2	0.1	0.1	0.0	0.0	0.0	0.0	0.1
Consumer goods, n.e.s.	3.8	3.8	3.7	3.1	3.5	3.4	3.3	3.9
Durable	0.9	0.8	0.7	0.4	0.6	0.6	0.6	0.9
Semi-durables	1.4	1.4	1.4	1.2	1.3	1.4	1.2	1.4
Non-durables	1.6	1.5	1.6	1.4	1.6	1.3	1.5	1.6
4 Dual use goods	**2.8**	**2.9**	**2.8**	**1.7**	**2.0**	**2.1**	**2.1**	**2.0**
Fuel and lubricants, processed, motor spirit	0.6	0.7	0.9	1.0	0.7	0.8	0.9	0.8
Transport equipment, passenger motor cars	2.2	2.2	2.0	0.7	1.3	1.3	1.2	1.2
Total	**17.7**	**22.2**	**17.9**	**14.0**	**14.8**	**16.0**	**18.0**	**18.2**

Source: Department of Statistics, Malaysia

The growth in imports of intermediate inputs correlates closely with the growth in manufacturing production index and manufactured exports. Monthly data for the period 1996 to 2001 indicate that intermediate imports is a leading indicator for manufacturing exports. While growth in manufacturing exports used to lag by several months the growth in intermediate imports, growth in manufactured exports and imports of intermediate goods have moved in tandem since the first quarter of 2002, reflecting lower holding of inventories and wider implementation of just-in-time production.

Manufactured Exports and Intermediate Imports



Reflecting the sustained growth in private consumption, imports of primary and processed materials used for the food and beverages industry registered an increase of 31.4% during the quarter. Consonant with sustained private spending, imports of consumption goods increased by 4.7%. Imports of capital goods, excluding lumpy imports, increased by 0.3%, reflecting continued growth in investment.

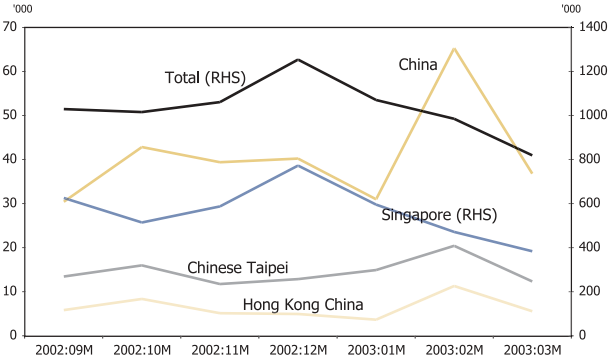
Malaysia: Imports by Economic Function: Broad Economic Categories (BEC) Classification

	2002		2003	
	1Q	4Q	1Q	
	Annual change in %			RM mil
CAPITAL GOODS	**-9.9**	**6.6**	**-5.0**	**9,678**
Capital goods (except transport equipment)	-11.7	7.5	0.2	9,148
Transport equipment	9.1	-11.7	-49.9	530
INTERMEDIATE GOODS	**-5.8**	**7.0**	**2.5**	**51,354**
Food and beverages, mainly for industry	33.8	0.9	31.4	1,550
Industrial supplies, n.e.s.	-8.3	10.7	7.5	15,686
Fuel and lubricants	-4.1	17.4	30.9	3,180
Parts and accessories of capital goods (except transport equipment)	-7.6	5.3	-2.9	29,399
Parts and accessories of transport equipment	50.5	-6.8	-3.9	1,540
CONSUMPTION GOODS	**6.7**	**22.1**	**4.7**	**4,499**
Food and beverages, mainly for household consumption	3.7	-8.0	0.5	1,762
Transport equipment, non-industrial	23.9	28.7	110.2	74
Consumer goods,n.e.s.	8.7	49.1	6.1	2,663
Durables	19.0	154.6	15.3	630
Semi-durables	4.8	28.0	-10.2	842
Non-durables	7.4	23.8	16.2	1,190
DUAL USE GOODS	**-10.3**	**16.2**	**28.8**	**1,784**
OTHERS	**43.2**	**14.4**	**3.4**	**1,582**
RETAINED IMPORTS	**-5.1**	**8.2**	**2.1**	**68,897**
RE-EXPORTS	**7.8**	**40.5**	**12.1**	**1,875**
GROSS IMPORTS	**-4.8**	**9.0**	**2.3**	**70,772**

Sustained Tourist Arrivals

Tourist arrivals remained steady at 2.9 million for the quarter despite the heightened geopolitical risk. Tourist arrivals were sustained at a monthly average of one million arrivals but declined to 0.8 million in March due mainly to the onset of SARS. The SARS impact, with the issue of the WHO travel advisory beginning mid-March, was more concentrated among tourist arrivals from Singapore and Hong Kong China. The decline in arrivals from Singapore and Hong Kong China was mitigated by higher number of visitors from the other countries, including double-digit growth in tourists from Brunei (53.2%), Africa (45.8%), Thailand (28.9%), West Asia (23.5%) and US (10.3%). Going forward, measures announced in the economic stimulus package on 21 May provides further support to the tourism industry to offer attractive packages to encourage the return of tourists.

Monthly Tourist Arrivals



Source: Malaysian Tourism Promotion Board

The Cash BOP Reporting System of Bank Negara Malaysia showed that gross inflow of FDI in the form of direct equity and inter-company loans (excluding retained earnings) amounted to RM3.1 billion in the first quarter, compared to the gross FDI inflow of RM2.9 billion in the first quarter of 2002.

In terms of composition, gross inflows of FDI during the first quarter were mainly through inter-company loans. About 60% of the loans were received from a related company by an MNC, through its centralised treasury operations in Malaysia. Direct equity inflows continued to be channelled into the manufacturing sector and the oil and gas sector. Outflows of FDI during the first quarter reflected largely the higher repayment of short-term inter-company loans, and payment for acquisition of foreign interests in the gas sector by a Malaysian company. The latter was attributed to the

expiry of a joint venture agreement in the production of liquefied natural gas. After taking into account the gross outflows, FDI recorded a net outflow of RM3.3 billion. The outflows were mainly to fund the change in ownership of business interests from non-resident to residents, and thus did not have an impact on economic activity in the country.

The heightened uncertainty in the external environment led to lower investment abroad by Malaysian companies. Investment was mainly by the oil and gas sector and the manufacturing of composite component parts for the aerospace industry. There were also some inflows in the form of repayment of inter-company loans extended to subsidiaries or associates abroad. On a net basis, overseas investment recorded a reduced net outflow of RM1.1 billion (4Q 2002: -RM2.1 billion). Outflow of portfolio investment was also much lower at RM1.6 billion in the first quarter (4Q 2002: -RM3.7 billion).

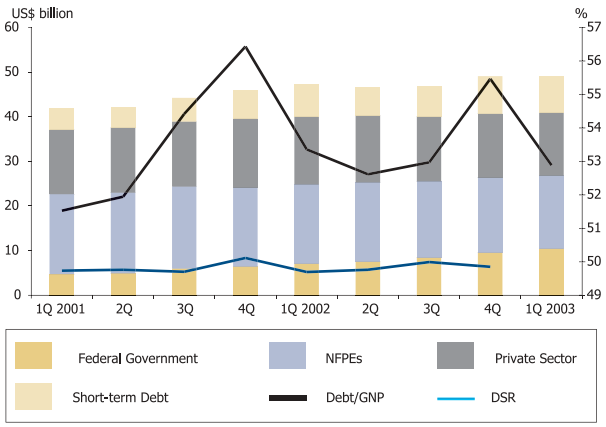
External debt remains manageable

Malaysia's total external debt stabilised at RM186.8 billion (US$49.1 billion) as at end-March 2003, equivalent to 52.9% of GNP. The **medium and long-term external debt**, increased marginally to RM155.9 billion or US$41 billion (4Q2002: RM154.4 billion) during the quarter, attributed mainly to the reclassification of a domestic foreign currency loan raised from Labuan banks into external loan. The external debt of the non-financial public enterprises (NFPEs), which had been on the downward trend since the third quarter of 2002, continued to record a smaller drawdown of RM413 million. Another positive development in the quarter was the full settlement of some large loans by the NFPEs, resulting in a large repayment of RM2.5 billion (4Q2002: RM1.7 billion). The drawdown of external loans of RM2 billion by the private sector, was mainly in the utilities and oil and gas sectors, while the bulk of the repayments were effected by companies operating in the electrical, telecommunication and chemicals industries.

External Debt Outstanding

	2002		2003
	1Q	4Q	1Q
	RM billion		
Medium & Long-term debt	152.2	154.4	155.9
Public sector	94.4	100.6	101.6
Private sector	57.8	53.8	54.3
Short-term debt	27.3	32.2	30.9
Total external debt	179.5	186.6	186.8
- US$ billion equivalent	47.2	49.1	49.1

External Debt



The total **short-term external debt** was lower at RM30.9 billion (US$8.1 billion), reflecting a decline in the revolving credits facilities of the non-bank private sector, arising mainly from the

repayment of these facilities by several major companies, particularly from the oil and gas sector. As at end-March, the short-term debt accounted for only 16.5% of total external debt, one of the lowest in the region and is about 23.3% of the net international reserves.

Reserves increased further

The rising trend in the international reserves of Bank Negara Malaysia continued during the first quarter. As at 31 March 2003, the net international reserves amounted to RM132.6 billion or US$34.9 billion, an increase of RM1.2 billion or US$0.3 billion since end-2002. The increase in reserves was attributed mainly to the sustained repatriation of export earnings and to a lesser extent, steady inflow of investment income. The reserves level had also taken into account the unrealised foreign exchange revaluation gain arising from the quarterly adjustment of reserves amounting to US$211 million, mainly as a result of the appreciation of euro against the US dollar during the first quarter. The international reserves increased further by RM7.1 billion or US$1.9 billion during April to the first half of June to RM139.7 billion or US$36.8 billion as at 13 June 2003. The reserves position is adequate to finance 5.7 months of retained imports and is 4.6 times the short-term external debt.

Federal Government Finance

Fiscal stance remained expansionary

In the first quarter, the fiscal stance remained expansionary. Development expenditure increased substantially to support domestic economic activities. Together with traditionally lower revenue collection during the quarter, the Federal Government's financial position recorded a higher deficit.

Federal Government Finance [p]

	2002		2003
	1st. qtr.	4th. qtr.	1st. qtr.
	RM million		
Revenue	17,143	27,341	14,748
Operating expenditure	14,716	22,538	11,650
Current account	**2,427**	**4,803**	**3,098**
(% of GDP)	***2.9***	***5.0***	***3.3***
Net development expenditure	3,713	14,616	7,775
Gross expenditure	*3,892*	*15,162*	*7,840*
Less: Loan recoveries	*179*	*546*	*65*
Overall balance	**-1,286**	**-9,813**	**-4,677**
(% of GDP)	***-1.5***	***-10.1***	***-5.0***
Sources of financing:			
Net domestic borrowing	-2,400	3,976	8,800
Net foreign borrowing	2,929	2,611	-26
Realisable assets[1]	757	3,164	-4,100
Total	**1,286**	**9,813**	**4,677**

[p] Preliminary.

[1] Include changes in Government Trust Fund balances. A decrease in accumulated realisable assets is indicated by a positive (+) sign.

Source: Accountant General of Malaysia

The more moderate Federal Government revenue during the quarter reflected lower collection of both corporate income tax (-31%) and individual income tax (-2%). Lower corporate income tax was due largely to the high base in 2002. Collections were also affected by the tax incentives given in the 2003 Budget to increase domestic investment in niche areas in the services, agriculture and manufacturing sectors. Tax incentives were also given to businesses to reduce their cost of operations. Other direct taxes collection, particularly stamp duties were also lower due to subdued performances of both the stock and residential property markets.

Federal Government Revenue [p]

	2002		2003	
	1st. qtr.	4th. qtr.	1st. qtr.	
	RM million			% share
Tax revenue	14,384	19,542	12,445	84.4
Direct taxes	9,766	12,705	8,361	56.7
of which:				
Income tax	9,381	12,124	7,973	54.1
Corporate	*5,108*	*8,907*	*3,551*	*24.1*
Petroleum	*500*	*2,324*	*707*	*4.8*
Personal	*3,772*	*853*	*3,686*	*25.0*
Co-operative	*1*	*41*	*29*	*0.2*
Stamp duties	346	463	326	2.2
Real property gains tax	26	104	51	0.3
Indirect taxes	4,618	6,836	4,084	27.7
of which:				
Export duties	149	285	223	1.5
Import duties	709	1,037	670	4.5
Excise duties	1,057	1,299	989	6.7
Sales tax	1,896	2,903	1,474	10.0
Service tax	390	752	378	2.6
Non-tax revenue & non-revenue receipts	2,758	7,800	2,303	15.6
Total	**17,143**	**27,341**	**14,748**	**100.0**

[p] Preliminary.

Source: Accountant General of Malaysia

In the indirect taxes category, receipts from export duties were higher (+50%) due to higher prices of petroleum (US$32.64 per barrel in the first quarter of 2003 against US$20.23 per barrel in the corresponding quarter). Collection of sales tax was lower (-22%) due to larger revenue foregone arising from the subsidy transferred to maintain stable prices for retail petrol pump as well as lower sales of cars. The lower car sales also resulted in lower collection of excise duties (-6.5%). New tax measures also affected collection of service taxes (-2.9%). Measures included service tax exemption for courier service provided from a point within Malaysia to a destination outside Malaysia, and

selected professional services provided to companies within the same group. Meanwhile, collection of import duties was lower (-5.5%) in almost all sub-sectors.

At the same time, total expenditure increased by 4.7% to RM19.5 billion due entirely to higher development expenditure. Higher development expenditure was expended mainly for social and economic programmes. In terms of allocation, expenditure was mainly channelled for education (37.5%), infrastructure (13.5%) and industrial development (12.8%).

Higher Federal Government debt - but within sustainable level

The outstanding debt of the Federal Government was higher at RM175.3 billion as at end-March 2003. In terms of GDP, the level of debt was contained at 45.9% of GDP (45.7% of GDP as at end-2002). This level of debt remained manageable, with domestic debt accounting for 78% of the total debt.

The net increase in outstanding debt reflected mainly the increase in net domestic borrowings. The issuance of government securities in the domestic market during the quarter under review amounted to RM19.1 billion. The Federal Government floated five issues of Malaysian Government Securities (MGS) totalling RM17.1 billion by way of open tender through principal dealers, as well as via private placements. A sole issue of the Government Investment Issues (GII) amounting to RM2 billion was also raised. Given the ample liquidity situation, the issuance of these securities did not 'crowd out' the private sector's financing requirements. After adjusting the reclassification of a foreign-denominated syndicated loan as external debt, the total outstanding domestic debt of the Federal Government stood at RM135.9 billion as at end-March 2003.

As part of prudent debt management to reduce the cost of debt servicing, the Federal Government refinanced its dual-currency syndicated loan raised in 1999. Outstanding external debt of the Federal Government increased from RM36.3 billion as at end-December 2002 to RM39.4 billion as at end of March 2002, due mainly to the reclassification of a foreign-denominated syndicated loan. The loan, which was raised in Labuan, was previously classified as a domestic loan. The Federal Government external debt remains low accounting for 21% of the nation's outstanding debt.

Federal Government Debt

	Change over preceding period			As at end of March 2003	
	2002		2003		
	1Q	4Q	1Q		
	RM million				% share
Domestic debt	-2,424	4,118	7,211	135,891	77.5
Government securities	-2,400	4,000	6,800	116,350	66.4
Other loans[1]	-24	118	411	19,541	11.1
External debt	2,665	4,160	3,114	39,397	22.5
Market loans	2,770	3,612	3,137	31,811	18.1
Project loans	-105	548	-23	7,586	4.3
Total	242	8,278	10,326	175,289	100.0

[1] Include Treasury bills, Investment Issues, loans to the Treasury Housing Loans Division and foreign-denominated syndicated loan. In 2003, foreign-denominated syndicated loan was reclassified as external debt.

Numbers may not add up due to rounding.

Monetary and Financial Developments

Monetary policy remained accommodative in the first quarter of 2003 to support domestic economic activity. Interbank and retail rates continued to remain low and stable. Liquidity remained ample. Reflecting the low borrowing costs and continued access to financing, financing activity of the private sector was sustained during the quarter. Total gross financing through the banking

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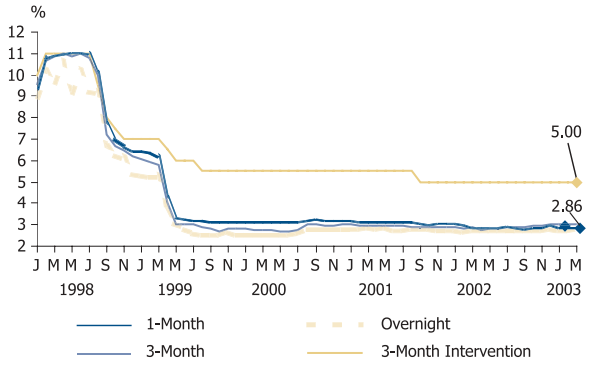
system and capital market expanded at an annual rate of 12.2%.

Low interest rates sustained economic activities

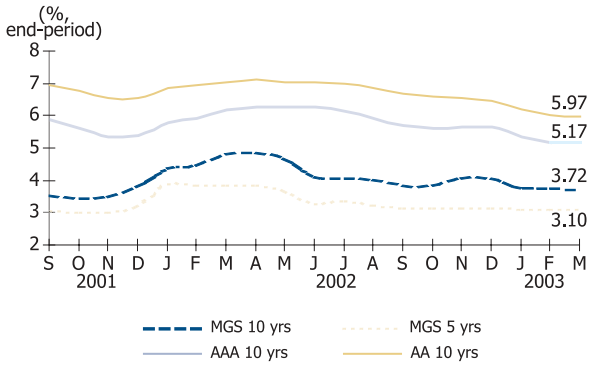
In the first quarter, interest rates remained stable. The monthly weighted average rates for the overnight and 1-week maturities hovered around 2.75-2.81% and 2.78-2.83% during the period (4Q 2002: 2.74-2.79% and 2.76-2.88%), while the 1-month rate stabilised at 2.99% during the period. Meanwhile, the yields of the 5-year and 10-year Malaysian Government Securities (MGS) were lower at 3.098% and 3.722% as at end-March (December: 3.153% and 4.058% respectively). A similar trend was observed in the implied yield of the 3-month Klibor Futures, reflecting market expectations that the interest rates would remain low in the near term.

Interbank Rates
(average for the month)



Borrowers benefited from competitive credit market. Multi-tiered housing loan products and hire purchase rates were offered at below the BLR. While the average lending rates of commercial banks remained stable, the **average lending rates** of finance companies (FCs) continued to decline in

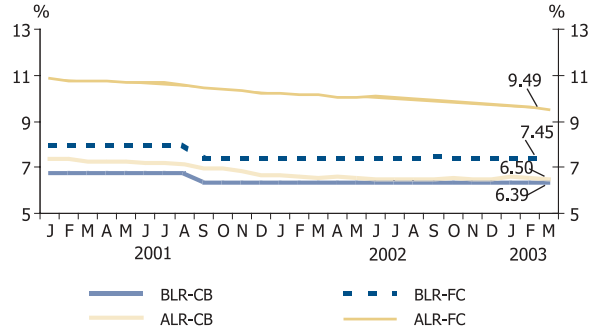
Long-term Interest Rates



March. Given the low inflation during the quarter, depositors continued to enjoy positive real returns on their deposits.

Against a background of modest growth and rising deflationary pressures in the major economies and the increased uncertainties arising from the financial market volatilities, a pre-emptive step was taken to reduce the 3-month Intervention Rate by 50 basis points to 4.5% on 21 May. With the reduction in the policy rate, the ceiling base lending rate (BLR) for CBs and FCs declined to 6% and 6.94% respectively, from 6.42% and 7.46% respectively. Reflecting the lower BLR ceiling, the average BLR of CBs and FCs as at 27 May were 6% and 6.90%

Lending Rates: Commercial Banks (CBs) and Finance Companies (FCs)

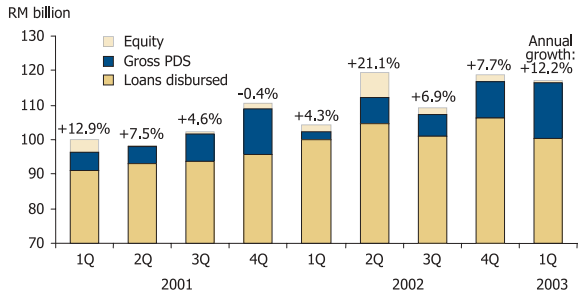


respectively (end-April: 6.39% and 7.45% respectively).

Bank lending activity was sustained

During the quarter, bank lending activity was sustained. Loans disbursements amounted to RM100.4 billion, about the level recorded in the fourth quarter of 2002. Of significance, applications and approvals increased by 14.4% and 14.1%

Gross Private Sector Financing through Banking System Loans and Capital Market

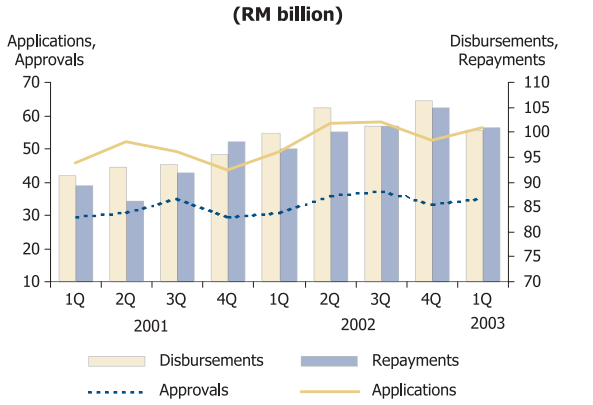


Banking System: Loan Indicators

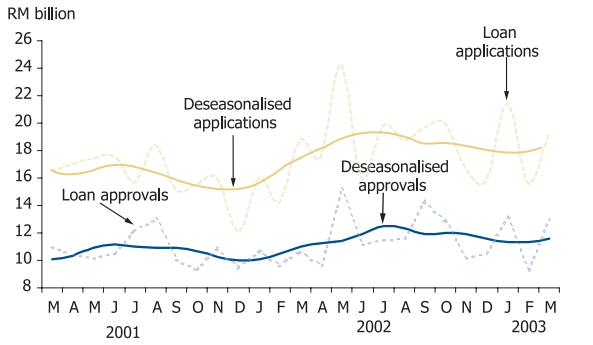
	During the quarter			Annual growth	
	2002		2003	2002	2003
	1Q	4Q	1Q	4Q	1Q
	RM billion			(%)	
Total					
Loan applications	49.0	52.5	56.1	n.a.	14.4
Loan approvals	30.9	33.6	35.3	13.6	14.1
Loan disbursements	99.9	106.0	100.4	10.9	0.5
Loan repayments	96.7	104.9	100.9	7.0	4.3
Change in loans outstanding	5.8	2.7	1.2	4.2*	3.2*
of which:					
Business enterprises					
Loan applications	34.3	31.6	33.7	n.a.	-1.6
Loan approvals	15.1	16.6	18.1	21.8	19.7
Loan disbursements	68.0	72.6	68.1	8.6	0.2
Loan repayments	65.8	71.2	69.4	-2.9	5.5
Change in loans outstanding	-0.5	1.8	-4.5	-1.2*	-2.8*
Households					
Loan applications	17.7	20.4	21.0	n.a.	18.2
Loan approvals	14.9	16.7	16.0	11.2	7.5
Loan disbursements	25.6	27.3	26.2	12.2	2.4
Loan repayments	20.7	22.0	22.5	16.4	8.5
Change in loans outstanding	6.0	5.7	5.0	14.5*	13.5*

* Annual growth at end-period

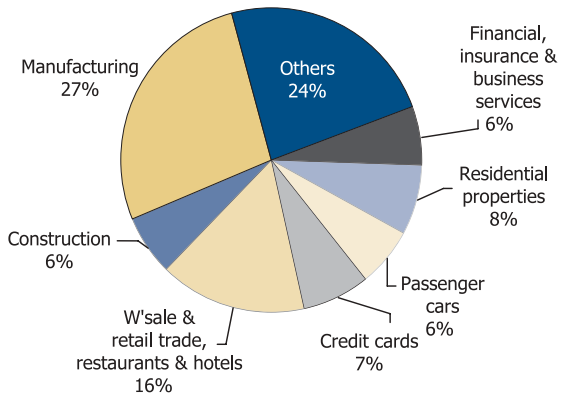
Loan Indicators



Deseasonalised Loan Indicators



Loan Disbursements in 1st Quarter 2003
(RM100.4 billion)



Banking System:
Loans Outstanding by Sector

	Change			Outstanding
	2002		2003	2003
	1Q	4Q	1Q	End-March
	RM billion			
Banking system loans outstanding, of which :				
Business enterprises	-0.5	-1.8	-4.5	247.6
Households	6.0	5.7	5.0	211.8
By sector				
Agriculture, hunting, forestry and fishing	-0.3	0.2	-0.3	12.0
Mining and quarrying	-0.3	-0.1	...	1.2
Manufacturing	1.0	-0.3	-0.8	66.4
Broad property sector	2.6	2.0	2.9	189.3
Construction	*-0.2*	*-0.9*	*-0.3*	*37.9*
Purchase of residential property	*3.2*	*3.5*	*3.5*	*104.7*
Purchase of non-residential property	*-0.3*	*-0.2*	*...*	*29.6*
Real estate	*-0.1*	*-0.4*	*-0.2*	*17.1*
Electricity, gas and water supply	-0.4	0.4	-0.6	6.2
Wholesale & retail trade, restaurants and hotels	-0.1	0.2	-0.5	39.0
Transport, storage and communication	-0.2	-0.5	-0.8	11.0
Financial, insurance and business services	0.2	-0.6	-0.7	32.0
Consumption credit	3.0	2.6	1.3	82.7
Of which:				
Credit cards	*0.2*	*0.6*	*0.1*	*10.8*
Purchase of passenger cars	*2.7*	*1.9*	*1.2*	*56.3*
Purchase of securities	0.2	0.6	-0.9	29.7
Purchase of transport vehicles	-0.3	-0.5	...	3.1
Others	0.4	-1.3	1.5	18.9
Total loans outstanding[1]	**5.8**	**2.7**	**1.2**	**491.4**

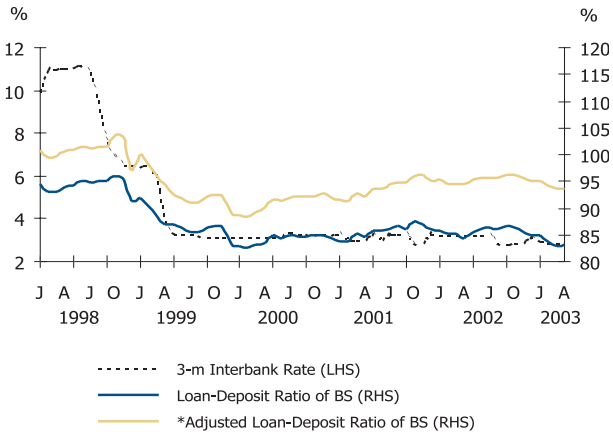
[1] Including loans sold to Cagamas and Danaharta.

respectively compared with the corresponding quarter of 2002 (6.8% and 5.1% respectively compared with the preceding quarter). The increase in loan applications mainly reflected the demand for loans from the household sector. Applications for housing and car loans rose at an annual rate of 14.7% and 30.2% respectively compared with the corresponding quarter of 2002 (2.4 and 3.6% respectively compared with the preceding quarter).

Loans outstanding increased moderately by RM1.2 billion in the first quarter (4Q 2002: +RM2.7 billion; 1Q 2002: +RM5.8 billion). The moderate increase in loans outstanding reflected the high repayments and loans written off. On an annual basis, loans outstanding rose by 3.2% at end-March (4.2% at end-2002).

Consequently, the loans-deposit ratio stood at 83% at end-March (89.2% as at end-96 and 87.4% in 1980 and 1990). Including holdings of private and Government debt securities by the banking system, the loans-deposit stood at 93.7% at end-March.

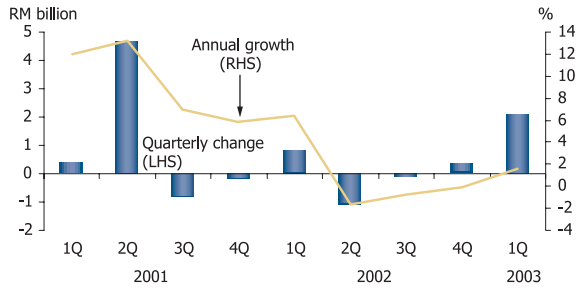
Liquidity Situation



* Includes banking system investment in private debt securities (PDS).

A positive development during the quarter was that outstanding loans extended to the small and medium enterprises (SMEs) expanded further by RM2.1 billion (4Q 2002: +RM0.3 billion; 1Q 2002: +RM0.8 billion). The bulk of these funds were channelled to the manufacturing sector and wholesale trade. Reflecting the increasing importance of SMEs in sustaining business activity and the proactive role of the banking institutions in providing financing to the sector during the quarter,

Loans to Small and Medium Industries



Banking System: Small Loans to Businesses

	Change (RM billion)			Annual growth (%)		% share of total loans	
	2002		2003		2003		2003
	1Q	4Q	1Q	2002	Mar	2002	Mar
Outstanding loans to businesses of size:							
Below RM500,000	3.1	-0.1	0.3	5.1	-0.2	12.4	12.4
Below RM100,000	3.6	-0.4	0.6	18.9	2.8	5.0	5.2
RM100,000 - RM500,000	-0.5	0.3	-0.4	-2.7	-2.3	7.4	7.3

the share of SME loans to total loans outstanding, has continued to increase to 17.9% at end-March (17.4% at end-2002).

Lending activities under the special funds also rose during the first quarter of 2003. Disbursements under the six active special funds increased further by 21% during the quarter. Applications and approvals were also higher by 9% and 14% respectively. As a result, outstanding loans extended under these funds increased by RM432 million (+RM149 million in 4Q 2002 and RM174 million in 1Q 2002). As part of the continuous effort to ensure access to funds at reasonable costs to the SMEs, the size of two special funds were expanded in March. The allocation to Fund for Small and Medium Industries 2 (FSMI2) was increased by RM600 million to RM1,250 million, while the allocation of funds for the New Entrepreneurs Fund 2 (NEF2) was raised by RM400 million to RM900 million.

In tandem with the continued expansion in economic activities, all three monetary aggregates continued to expand, with M1, M2 and M3 growing by 8.4%, 5.6% and 6.7% respectively as at end-March (10.3%, 5.8%, 6.7% as at end-2002). Reflecting sustained consumption spending, the demand for transaction balances remained strong during the quarter. Increased bank financing activities of the private sector (RM7.2 billion) provided the main impetus to broad money expansion (RM12.6 billion; RM11 billion in the fourth quarter). In addition, expansionary Government operations (RM4.7 billion) also contributed to the increase in M3 as the Government withdrew its deposits from BNM to finance its outlays. In the first quarter, higher deposits were mobilised from individuals and business enterprises mainly in the form of fixed deposits. Improved income over recent years saw higher placements of deposits by individuals, raising the individuals' share to total

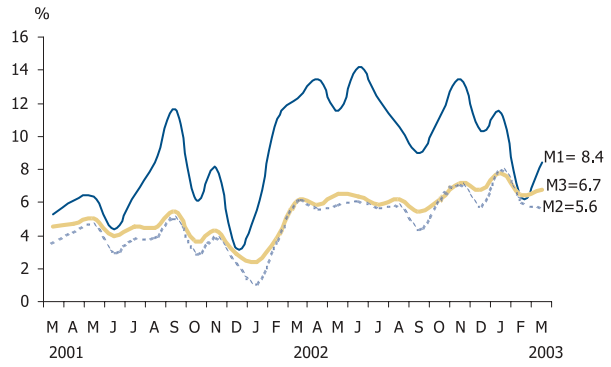
Status of Selected Special Funds

	Approvals			Utilisation Rate		Disbursements			Outstanding		
	As at end		Change			As at end		Change	As at end		Change
	2002	Mar-03	1Q 2003	2002	Mar-03	2002	Mar-03	1Q 2003	2002	Mar-03	1Q 2003
Fund for Food	1,296	1,340	44	99.7	103.0	1,124	1,170	46	675	683	9
New Entrepreneur Fund 2	652	780	128	130.4	86.7	326	467	141	316	452	136
Fund for SMIs 2	1,049	1,310	261	161.4	104.8	510	819	309	457	749	292
Bumiputera Entrepreneur Project Fund	317	377	61	105.6	125.7	257	283	26	111	102	(9)
Rehabilitation Fund for SMIs	323	324	1	64.5	64.7	284	293	9	240	245	5
Entreprenuer Rehabilitation & Development Fund	2	3	1	0.4	0.6	1	1	-	1	1	-
TOTAL	**3,638**	**4,133**	**495**	**97.0**	**87.0**	**2,503**	**3,033**	**530**	**1,800**	**2,232**	**432**

Note: The size of FSMI2 and NEF2 was expanded in March 2003 by RM600 million and RM400 million respectively.

deposits from 40.9% at the end of 1996 to 47.6% at the end of March 2003.

Monetary Aggregates: Annual Growth



Capital Market

The capital market remained a significant source of financing

Total **funds raised in the capital market** were significantly higher in the first quarter of 2003. In the public sector, total funds raised amounted to RM20.3 billion, mainly raised through the issuance of Malaysian Government Securities (MGS). During the period, there were three new MGS issued and two re-openings. There were also redemptions of MGS which amounted to RM10.3 billion.

Net funds raised in the private sector were also significant amounting to RM15.8 billion. Funds raised through the private debt securities (PDS) market were RM15.2 billion, issued mainly by a major corporation for its debt restructuring purpose. In the equity market, total funds raised amounted to RM542 million. During the quarter, there was a total of 12 IPOs issued, of which two were listed on the Main Board, three on the Second Board while another six on MESDAQ Market. The amount raised through the IPOs totalled RM236.1 million and was issued mainly by companies in the technology, consumer and industrial products sectors.

Funds Raised in the Capital Market

	2002		2003[p]
	1Q	4Q	1Q
	RM million		
By Public Sector			
Government Securities, *gross*	3,408	6,000	17,730
Less Redemptions	5,400	2,000	10,300
Less Government holdings	0	0	0
Equals Net Federal receipts	(1,992)	4,000	7,430
Khazanah Bonds *net*	0	0	878
Govt. Investment Issues *net*	0	738	1,729
Malaysia Savings Bond *net*	472	(2)	(2)
Net Funds Raised	(1,520)	4,736	10,035
By Private Sector			
Shares	2,051	2,112	542
Debt securities[1]	4,850	11,701	17,405
Less Redemptions	3,669	10,271	2,176
Equals Net issues	1,181	1,430	15,229
Net Funds Raised	3,232	3,542	15,772
Total Net Funds Raised	1,712	8,278	25,806
Short-term Papers and Notes *net* [2]	(1,461)	413	743
Total	251	8,691	26,549

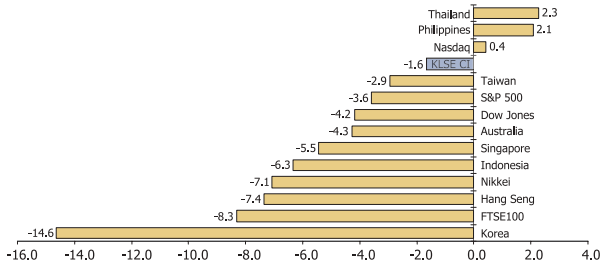
[1] Excludes debt securities issued by banking institutions.
[2] Refers to Commercial Papers and Cagamas Notes only.
[p] Preliminary.

Performance of KLSE affected mainly by external developments

The performance of the Kuala Lumpur Stock Exchange (KLSE) in the first quarter of 2003 was subdued, with sentiment affected mainly by external developments, particularly expectations on the impact of the war in Iraq. In January, the market commenced on a positive note, supported by an earlier announcement of the establishment of a new fund management company owned by public sector related trust funds as well as several encouraging corporate developments. However, the market eased gradually thereafter, affected by uncertainties on the global economic outlook following increased

geopolitical tensions in the Middle East. In the later part of March, the market performance improved slightly following expectations of a brief war. For the quarter as a whole, the KLSE Composite Index (KLSE CI) declined by 10.6 points or 1.6% since end-2002, to close at 635.72 points. Market capitalisation declined by 0.9% since the end of 2002 to RM477.39 billion. Nevertheless, total trading volume increased by 39.3% during the quarter, with 12.4 billion units traded and valued at RM21.3 billion. On a daily average basis, volume traded during the quarter was also higher. The KLSE CI has fared relatively better than most selected regional and global markets in the first quarter of 2003.

Performance of Selected Global and Regional Markets in the First Quarter of 2003



KLSE: Selected Market Indicators

	As at end				
	2002				2003
	1Q	2Q	3Q	4Q	1Q
Price Indices					
- Composite	756.10	725.44	638.01	646.32	635.72
- EMAS	181.72	176.5	155.39	157.25	153.98
- Second Board	132.29	119.84	102.89	98.24	93.00
Average daily turnover					
- Volume (million units)	304.9	299.3	159.1	143.4	213.6
- Value (RM million)	636.1	643.8	349.2	275.8	367.1
Market capitalisation (RM b)	517.63	505.89	476.35	481.62	478.3
No. of companies listed	826	843	859	865	874

KLSE: Turnover of Corporate Securities

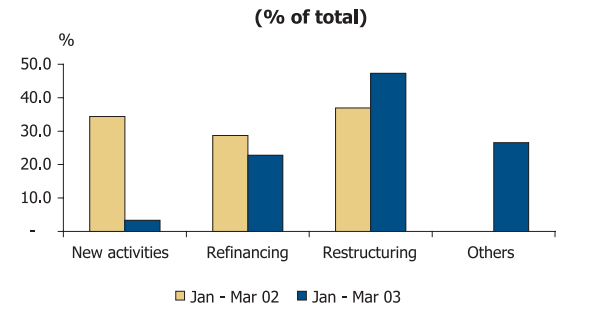
	2002				2003	
	1Q		4Q		1Q	
	million units	RM million	million units	RM million	million units	RM million
Turnover	17,684	36,895	8,890	17,098	12,387	21,294
of which:						
Main Board	14,769	31,045	7,276	14,914	10,609	19,397
of which						
- Consumer Products	647	2,616	255	1,095	309	1,481
- Industrial Products	1,291	1,747	575	1,213	711	1,535
- Construction	1,185	2,660	869	1,199	1,482	1,687
- Trading/Services	3,073	10,173	1,791	5,384	2,791	7,165
- Finance	2,670	7,418	1,244	3,335	1,532	3,784
- Properties	1,522	1,378	996	749	1,370	966
- Plantations	341	1,269	178	737	296	1,283
- Mining	62	112	38	72	48	91
Second Board	2,888	5,814	1,523	2,162	1,591	1,807

Higher funds raised in the bond market

The ringgit bond market remained a significant source of financing during the first quarter. Total net funds raised amounted to RM25.3 billion, of which RM15.2 billion were raised by the private sector. The low interest rates environment continued to provide a conducive setting for companies to issue long-term debt at competitive costs. Funds raised were mainly for refinancing and restructuring purposes, accounting for 47.3% and 22.8% of total funds raised respectively. In terms of tenure, the private debt securities (PDS) issued were mostly within the range of 1 to 5 years (47% of total) followed by between 5 years to 10 years (43%). As at end of March, total bonds outstanding stood at RM298.6 billion, of which private sector bonds accounted for 54.8% of the total outstanding.

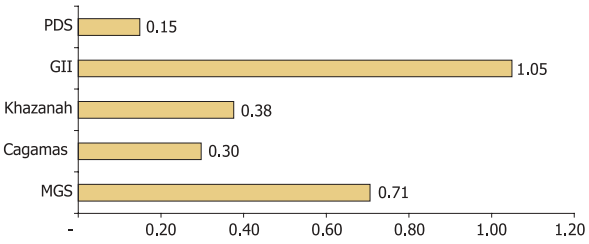
Secondary trading in bonds rose to RM132.2 billion (4Q 2002: RM114.4 billion) as investors

Private Debt Securities Issued by Purpose



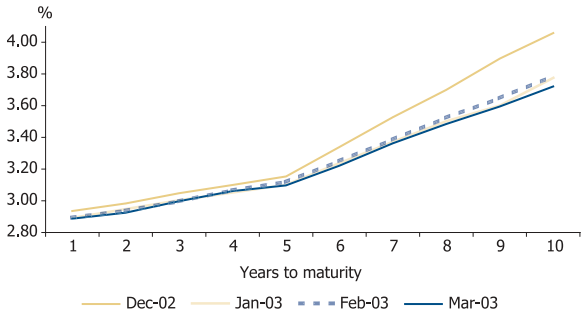
continued to shift to safe-haven investments during the period. Trading was concentrated in the Government and quasi-Government securities. The Malaysian Government Securities (MGS) and Government Investment Issues (GII) accounted for 67.7% of the total trade, while Cagamas bonds and Khazanah bonds contributed 8.1%. The GII and MGS were the most liquid papers, registering total turnovers of 1.1 and 0.7 times its outstanding amount respectively. Trading on corporate bonds centered mainly around higher-rated issues.

Monthly Liquidity Ratio: Turnover/Outstanding (1 Quarter 2003)



The increased interest in fixed income instruments had resulted in the downward shifting and the narrowing of yields. Amidst uncertainties over the Iraq war, investors' interests in the medium- to long-term papers increased, lowering the yields at the longer-end. Spreads between the MGS 5- and 10-year papers narrowed from 90 basis points in December 2002 to 62 basis points in March 2003. The corporate bond yields mirrored the movement of the MGS yields. The AA-rated papers registered the biggest decline in yields due to the higher interest in the AA-rated papers which provide higher return as well as the availability of more issues in this category.

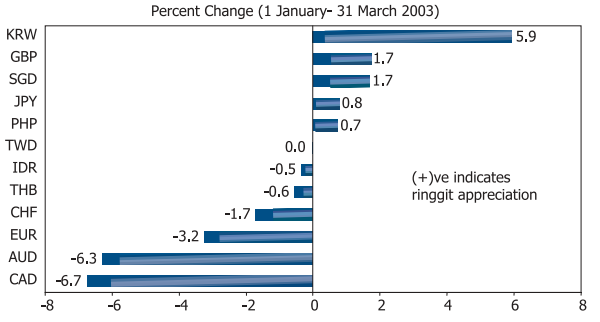
Trend in MGS Yield



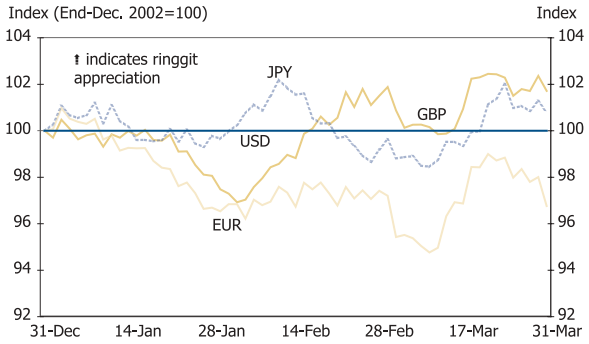
Exchange Rates

The ringgit recorded a mixed performance against both major and regional currencies in the first quarter of 2003, in tandem with the movements of the US dollar in the international foreign exchange markets (Charts 1, 2 and 3). The dollar was

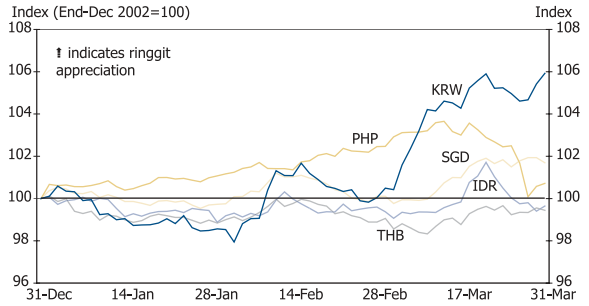
Summary of Ringgit Performance Against Selected Currencies



Ringgit Performance Against Major Currencies



Ringgit Performance Against Regional Currencies



adversely affected by market risk aversion resulting from developments in Iraq as well as positive interest rate differentials in favour of other major currencies. Of significance, the euro reached a 4-year high against the US dollar on 10 March due to capital inflows from the US. Among the regional currencies, the Korean won depreciated sharply due to the North Korean tensions and disclosures of a corporate misdemeanour involving the fourth largest conglomerate in Korea.

The ringgit exchange rate continues to be supported by a strong level of foreign exchange reserves, low inflation, continued surpluses in the current account, low external debt as well as a strong and resilient banking system.

Performance of Ringgit against Selected Currencies

RM per foreign currency	End-June 1997	2 September 1998	End 4Q 2002	End 1Q 2003	% change since[1] End-June 1997	% change since[1] 2 September 1998	% change since[1] End 4Q 2002
US dollar	2.5235	3.8000	3.8000	3.8000	-33.6	0.0	0.0
Euro	-	-	3.9811	4.1145	-	-	-3.2
Pound Sterling	4.1989	6.3708	6.0924	5.9898	-29.9	6.4	1.7
100 Japanese yen	2.2088	2.7742	3.2020	3.1774	-30.5	-12.7	0.8
Singapore dollar	1.7647	2.1998	2.1887	2.1523	-18.0	2.2	1.7
100 Thai baht	9.7470	9.3713	8.8096	8.8588	10.0	5.8	-0.6
100 Philippine peso	9.5878	8.8302	7.1462	7.0948	35.1	24.5	0.7
100 Indonesian rupiah	0.1038	0.0354	0.0425	0.0427	143.1	-17.1	-0.5
100 Korean won	0.2842	0.2827	0.3197	0.3019	-5.9	-6.4	5.9

Note:
[1] (+) indicates appreciation of ringgit against respective currency and (-) indicates depreciation.

REGULATION AND SUPERVISION

Developments in the Banking System

The banking sector exhibited resilience in the first quarter of 2003 amidst global uncertainty. The level of capital increased further following improved asset quality and higher profitability, hence enhancing the capacity of banking institutions. This stronger foundation would enable the banking system to support economic activities and enhance the resilience of the banking system in an environment of heightened uncertainty.

Strengthened capitalisation amidst higher profitability

The capital position of the banking system was sustained at stronger levels at end-March 2003. The risk weighted capital ratio (RWCR) improved to 13.1% from 12.8% at end-2002, whilst core capital ratio rose to 10.9% from 11.1% at end-2002. The higher expansion in capital base (2.8%) vis-à-vis expansion in the risk-weighted asset (1%) led to the stronger capital position.

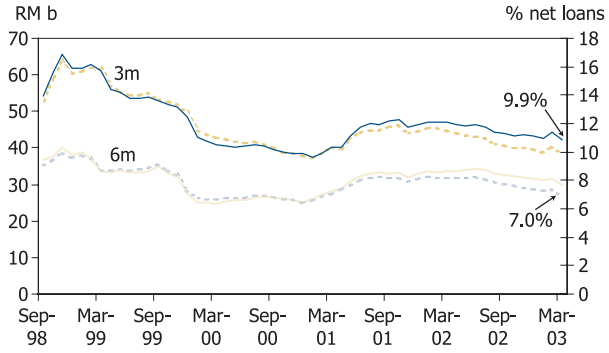
	2002				2003
	Mar.	Jun.	Sep.	Dec.	Mar.
Capital					
Core capital ratio (%)	10.8	10.9	11.0	11.1	10.9
RWCR (%)	12.6	13.2	13.3	12.8	13.1

Tier-1 capital rose by RM1.7 billion or 3%, mainly due to the increase in retained profits of RM1.3 billion and statutory reserves of RM0.8 billion. In tandem with strong lending activities, the risk-weighted assets (RWA) continued to expand.

High profitability sustained as quality of loan portfolio continued to improve

The banking system recorded an increase of 4.2% in net operating income to RM3.1 billion in the first quarter of 2003. This was attributed to the double impact of higher interest income and lower interest expense. As asset quality improved, provisioning requirements declined by RM1.8 billion. During the quarter, there was also substantial recoveries (+RM2.2 billion or 139.7%). As a result, profit before tax increased to RM2.8 billion in the first quarter, 4.4% higher than the level recorded in the preceding quarter.

Banking System: Non-performing Loans



Improved non-performing loans (NPL)

Non-performing loans declined further in the first quarter of 2003. Net NPL on a six-month classification reduced by RM1.8 billion to RM30 billion. Consequently, the net NPL ratio declined to 7.0% at end-March 2003. For the first time since the Asian crisis, the net NPL ratio on a three-month classification fell below 10%. The reduction was brought about by loan conversions and write-offs. The bulk of the conversion was due to the implementation of the restructuring scheme of a large corporate borrower under the CDRC exercise which took place in March 2003.

Total loans-in-arrears rose marginally by 0.3% to account for 10.2% of total outstanding loans at end-March 2003. This was largely attributed to an increase in arrears of between 1-3 months.

Loan loss coverage remained comfortable at 61.2% as end-March 2003, and even stronger at 156.2% if collateral was included.

Danaharta targeting to commence bond redemption by end-2003

Danaharta continued with its recovery efforts in order to maximise the recovery values from the NPLs. With an expected average recovery rate of 56% (48% for acquired loans and 63% for managed loans), Danaharta expects to receive RM29.5 billion from its total portfolio. Danaharta's total recovery collection amounted to RM20.3 billion at end-2002, representing 69% out of the total amount that it expects to recover from its portfolio. In line with the profit sharing arrangement with the selling institutions, Danaharta has, up to end-2002, distributed the surplus recovery amounting to RM371.1 million in cash and 55,899,542 units of securities to 30 financial institutions. In addition, Danaharta has also distributed a sum of RM11.9 billion being the gross cumulative recovery on the managed NPL portfolio. Danaharta has also utilised the cash proceeds to reduce its total borrowings to RM0.4 billion. The remaining RM6.5 billion cash it collected would be used to redeem the first tranche of zero-coupon bonds by end-2003.

Danamodal preparing for closure in 2003

The capital injection by Danamodal stood at RM2.1 billion at end-March 2003 in three banking institutions. Based on its shareholders funds of RM2.2 billion at the end of its financial year on 31 December 2002, and the value it would receive from the disposal of its total investments in equity and debt papers, Danamodal has the capacity to fully redeem its bonds when they mature in October 2003.

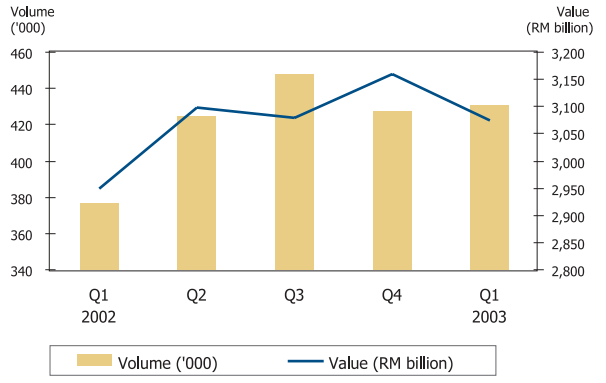
PAYMENT SYSTEMS

Developments and Trends in Payment Systems

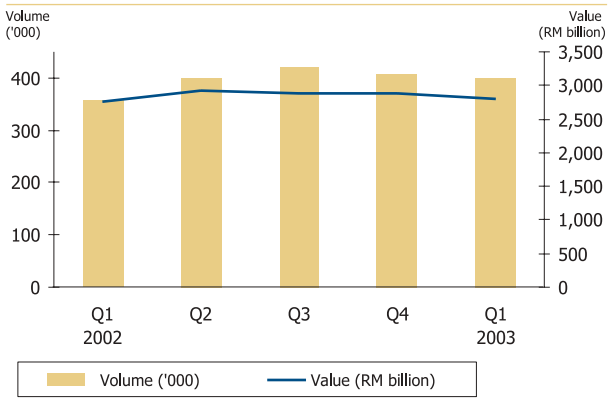
RENTAS

Overall, the RENTAS system effected 14.43% more transactions during the first quarter of 2003 than the first quarter of 2002 with an increase in value of 4.32%. In the first quarter of 2003, the volume and value of funds transferred through the Interbank Funds Transfer System (IFTS) of RENTAS declined by 1.66% to 400.2 million transactions and 3.24% to RM2.79 trillion respectively, compared with the last quarter of 2002. The volume and value of transactions processed through the Scripless Securities Trading System (SSTS), however, increased by 10.12% to 0.03 million and 3.19% to RM284.64 billion respectively.

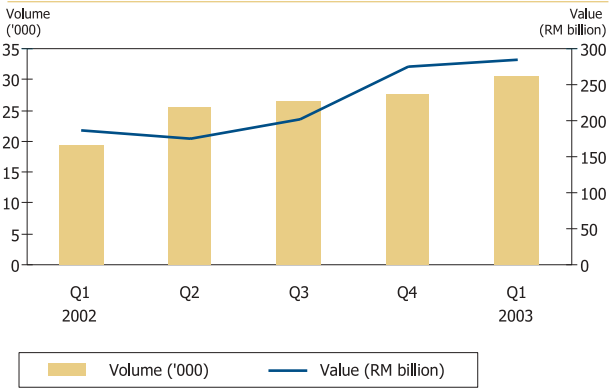
RENTAS Total Turnover



RENTAS IFTS Turnover



RENTAS SSTS Turnover

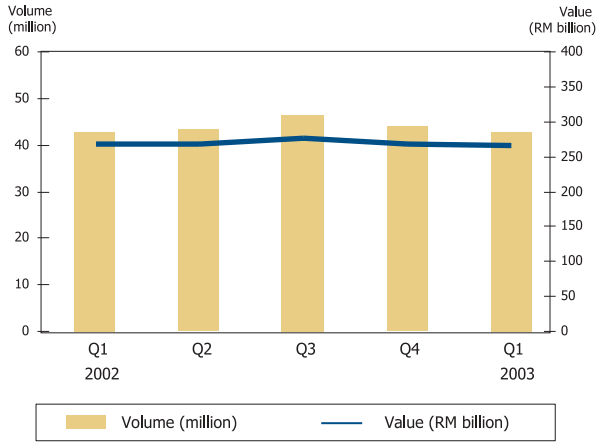


SPICK

All Ringgit denominated cheques are cleared through the SPICK (Sistem Penjelasan Imej Cek Kebangsaan) cheque clearing centres located in three regions of Malaysia, that is, the Northern, Central and Southern regions. The number of cheques cleared through the SPICK cheque clearing centres operated by Bank Negara Malaysia has been declining steadily over the last three quarters. In keeping with the progress made in encouraging the transfer of funds via electronic means, there has been a decline in the number of cheques cleared via the SPICK centres from the first quarter of 2002 and

2003 by 0.13% in volume and 1.07% in value. In the first quarter of 2003, the number of cheques processed declined slightly by 3.19% to 42.62 million, compared to the previous quarter. Accordingly, the value of cheques cleared through these centres has also declined, albeit at a lower rate of 1.31% to RM265.25 billion.

Value and Volume of Cheques Cleared by SPICK Centres



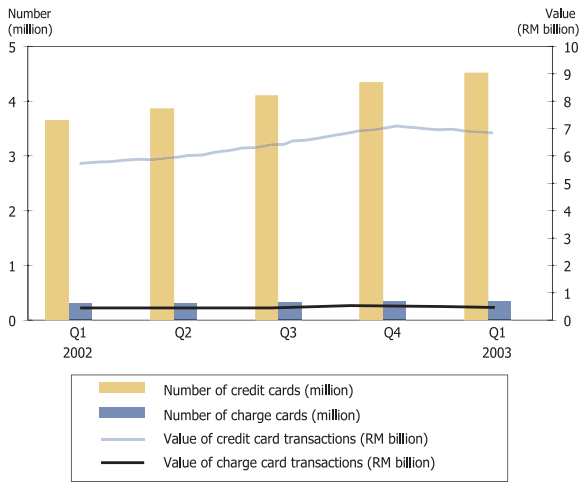
The Bankcard

During the first quarter of 2003, the volume of cash withdrawals via ATM declined by 0.34% to 49.27 million transactions from the previous quarter, while the amount withdrawn decreased by 0.49% to RM20.06 billion. During the same period, the domestic financial institutions successfully completed upgrading all ATMs to accept the chip-based payment card. The official launch of the Bankcard on 28 February 2003 brought to fruition one of the two types of smart card solutions under the Multipurpose Card Flagship Application, which is one of the seven Multimedia Super Corridor Flagship Applications. The MyKad is issued and implemented by the National Registration Department. As at the end of the first quarter 2003, more than 1.74 million Bankcards have been issued. Banking institutions are in the midst of upgrading their ATMs to enable MEPS Cash loading in the Bankcard and MyKad. Currently, a total of 2,500 ATMs, accounting for 66.0% of the total ATMs of the domestic banking institutions, have been upgraded for loading of MEPS Cash in the Bankcard and 445 ATMs or 11.5% for loading in MyKad.

Card Payment Instruments

The number of credit cards and charge cards in circulation increased by 3.9% to 4.53 million cards and 1.75% to 0.35 million cards respectively from the previous quarter. There had been strong growth in the credit card industry in Malaysia since the first quarter of 2002. The number of credit cards in circulation had increased by 24.2% and correspondingly, the value of transactions had increased by 19.18%. While there has been an increasing trend in the value of credit card and charge card transactions, it also reflects the seasonal pattern of consumption.

Credit Card and Charge Card Operations



Bank Negara Malaysia is also taking steps to increase consumer awareness and to promote the prudent use of credit cards. In addition, Bank Negara

Malaysia has issued a guideline on credit card operations on 18 March 2003 and issuers of credit cards are required to undertake the necessary system adjustments to ensure compliance within a period of six months.

The comprehensive new guidelines set out the minimum requirements on credit card operations revoking previously issued guidelines and covering new areas such as prudent lending requirements, usage of credit card for unlawful activities, supplementary cardholder's liability, liability for lost or stolen credit cards and placing added emphasis on consumer awareness and education programmes.

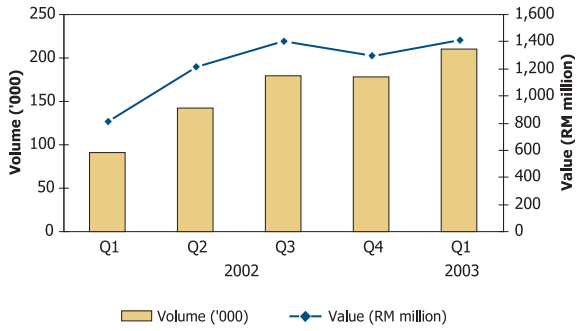
The usage of debit cards in Malaysia is still low, compared to credit and charge cards. Nevertheless, the number of debit card transactions has increased by 2.13% to 0.29 million transactions in the first quarter of 2003, and by 1.12% in terms of value to RM21.17 million.

As at end-March 2003, more than 3,400 card readers accepting MEPS Cash have been deployed by domestic banking institutions at various merchants nationwide. Besides banking institutions, third party acquirers are also participating in acquiring merchants for MEPS Cash. To promote awareness of MEPS Cash as the national e-purse scheme, banking institutions will be carrying out marketing campaigns to encourage usage of MEPS Cash as an alternative non-cash mode of payment. The government has supported the usage of MEPS Cash at all merchants as a means of payment.

Interbank GIRO (IBG)

The IBG system facilitates third party payments between the participating banking institutions to execute standing instructions such as loan repayment, insurance premiums, salaries, tax payments and contributions to the Employees Provident Fund. In comparison with the first quarter of 2002, there had been a dramatic increase in both the volume and value of 130.54% and 72.77% respectively. The volume and value of IBG transactions had increased during the first quarter of 2003 by 17.84% to 0.21 million transactions and 8.81% to RM1.41 billion from the fourth quarter of 2002. The increase in IBG transactions indicates that the electronic mode of payment is steadily gaining acceptance.

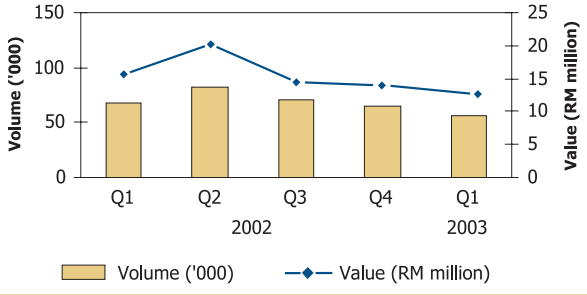
Interbank Giro Transactions



Payment Gateway

The volume and value of transactions effected through the MEPS payment gateways has decreased slightly during the first quarter of 2003 by 8.8% and 9.83% from the fourth quarter of 2002.

Payment Gateway Transactions



THE FIFTH ASIAN ROUNDTABLE ON CORPORATE GOVERNANCE SPECIAL DINNER ADDRESS

Corporate Governance : Towards preserving financial stability and sustainable growth

By Y. Bhg. Tan Sri Dato' Sri Dr. Zeti Akhtar Aziz
Governor, Bank Negara Malaysia
26 March 2003

Bismillahirrahmanirrahim

In this increasingly highly uncertain environment, management has become a key differentiating element in determining relative performance. For the financial sector, the Asian financial crisis in 1998 underscore the importance of maintaining financial stability as an enabling factor in achieving sustainable economic growth. This is even more evident in the context of a highly integrated global financial system where financial shocks are easily and rapidly transmitted across markets and to the domestic financial sector. The impact is particularly adverse and powerful if there is weakness in corporate governance. In Malaysia, the highest priority has been accorded to ensure financial stability. For emerging market economies, the challenge of achieving financial stability extends beyond the need for regulatory reform to the need to develop robust and efficient financial structures. The challenge to policy makers in this new environment is to preserve confidence and stability and to promote balanced and equitable growth. We have seen that financial restructuring efforts and measures to enhance corporate governance undertaken in the region has not only contributed to re-establishing and restoring confidence in the financial system, but has contributed to enhanced effectiveness and efficiency of the financial system.

In the Malaysian context, the financial and corporate sector restructuring, the consolidation process and other financial reforms that has been undertaken over the recent years have enhanced the strength and resilience of the banking system. The Bank Negara Malaysia Annual Report 2002 that has been released today indicates significant improvements in the strength and resilience of the banking system. The stronger balance sheet with the risk weighted capital ratio of 13% and the lower level of non-performing loans and provisioning have placed the banking institutions in a much stronger position to absorb shocks emanating from the current uncertain environment.

The long-term resilience of the banking system and the sustainability of economic growth with embedded self reinforcing elements of rising efficiency and productivity are however, critically dependent on building strong foundations of good corporate governance. While the progress in enhancing corporate governance has thus far been encouraging, the challenge of rapidly changing global and financial environment today demands more widespread and even higher standards of corporate governance than what we have achieved so far. In today's very challenging environment of heightened risks arising from globalisation, volatile and large financial flows and frequent tendencies for markets to overreact and for a prolonged period, strong corporate governance practices become the bulwark of risk mitigator and stability.

In addition, uncertainties arising from external developments including geopolitical

developments and their impact on the global economy and financial markets have made the need for sound management and strong corporate governance to be a core objective and target of corporates and financial institutions. Sustainable performance requires strong foundations to ride the economic cycle, ability to withstand unstable market conditions and overall adaptability to adjust to a rapidly changing environment. Decision-making would become more challenging and thus require the support of timely, reliable and transparent information as well as balanced processes for decision making. The need to consider the various forces of change has made it necessary for management to conduct in-depth analysis and adopt forward looking perspective that is able not only to manage short term targets but yet stay focus on the medium and long term strategic orientation and goals. We need to go beyond the bottom lines, and also focus on the broad range of factors that ensure long-term sustainable performance.

Ladies and Gentlemen,

It is my pleasure and indeed an honor to be invited to share with you my perspectives on "Corporate Governance". Corporate governance issues are indeed relevant given the series of corporate failures and the crisis of confidence over corporate excesses in both developed and developing countries. The accumulation of breakdowns in internal and external checks and balances and in the values of good governance and the narrowing of focus for personal gains at the expense of other stakeholders, have caused several large and high profile corporations to collapse under the weight of malpractice and frauds. The rising incidences of poor governance have resulted in the erosion of confidence among investors worldwide, raising the cost of capital, reduced access to financial markets and restrained the growth of productive initiatives and incurring high costs when public sector resources have to be utilized for bail out. These developments have resulted in a re-examination of the regulatory framework and the introduction of new and more demanding regulations. While these regulatory actions may serve to address the malpractices, a balance approach needs to be taken to ensure that its implementation will not have destabilising implications on the corporate sector. Here, the challenge is to strike a balance between Government regulation and self-regulation. My remarks this evening will focus specifically on the importance of corporate governance in the context of the financial sector, why it is critical in view of its profound impact on the financial stability and long-term sustainability of growth and dynamism of the economy.

Ladies and Gentlemen,

As the lynchpin of the economy, a well functioning and efficient banking system is vital for achieving robust and sustainable economic performance and thus improving the welfare and standards of living. In the context of a progressive and competitive economy, the banking institutions perform the very important function of efficiently channelling these savings for productive investments. In view of the special role that banking institutions have in the economy in performing the intermediation function of channelling funds between the savers and investors, high standards of integrity and governance in banking institutions is even more essential. The importance of sustaining confidence of depositors that entrust their funds to financial institutions cannot be compromised. While depositors need to be assured of the safety of their deposits, productive investment can only be self-reinforcing if the funds are efficiently allocated and

adequately reflect the opportunity cost of capital as well as the returns on investment.

Banking business involves risks and these risks need to be rigorously managed if public confidence in the banking system is to be preserved. These risks involve credit risk, market risks, sovereign risks and foreign exchange risks, to name a few. Because of the wide-impact on the whole economy, the business of banking is too important to be left to self-regulation. The regulatory framework that has been put in place is therefore a key part of the process to ensure the soundness and efficiency of the banking system while protecting the interest of depositors and investors.

However, while much can be done to enhance regulations, supervision and surveillance of the management of risks by the financial institutions, the final accountability and responsibility lies with the Board of Directors and senior management. The regulation of banking institutions therefore needs to be complemented and reinforced with strong internal corporate governance practices. In addition, the global experience has shown that not all banking failures were due to economic and financial crisis. Some banking failures were caused by the lack of good corporate governance. Lack of oversight, lack of transparency, weak internal controls, lack of check and balances, incompetent directors and abuse of power are among the elements of poor corporate governance. The best regulation and supervision and the best financial safety net would not prevent such banking failures. The regulation of banking institutions therefore needs to be complemented with good corporate governance. The special position financial institutions and the important role they play in the economy makes having good corporate governance framework even more vital. It is even more important than in the corporate sector given that most of the funds for their business belong to depositors. In addition, any failure of a banking institution affects not only the shareholders but could also have systemic implications on overall stability of the financial system.

In the context of the banking industry, corporate governance involves the manner in which the business and the affairs of the individual banking institutions are being governed by their board of directors and senior management, how the economic returns are generated to the owners and the consideration of the interests of recognised stakeholders including depositors' and how they behave in a safe and sound manner in compliance with applicable laws and regulations. In this context, the transparency in the conduct of banking institutions, facilitated by the proper accounting standards that reflect the true and fair value of banking operations would lead to greater accountability and responsibility on the part of the bank's management.

Corporate governance in the banking sector thus involves the range of practices covering proper conduct of business, values, ethics and the whole culture of organizational and staff behaviour. It not only involves process and financial targets to serve the interest of the shareholders but also best practices of conduct with depositors, customers and other stakeholders. While the board and senior management take responsibility of operational issues and financial targets, of equal importance is to provide sound leadership in dealing with all the stakeholders of the financial institutions. A progressive board and management will provide the leadership for financial institutions to grow, establish robust risk management policies and framework to absorb financial shocks and cyclical downturns.

Historical experience has shown that the lack of integrity, honesty, professionalism, poor controls and unhealthy assumption of risks are indeed the sure recipe for sub-optimal allocation of resources and the sub-performance of the economy.

Sustainable performance requires a re-examination of today's business models. In this more competitive environment the pressure of market to focus on short-term returns, no doubt have profound impact on banking business and the way it is run. Business models have tended to focus on shorter and shorter time horizons. The increasingly liberalized and globally integrated financial system and global market place have exposed Malaysian corporates to greater opportunities as well as risks. Similarly, advances and sophistication in information and communication technology would have direct impact on the relevance of existing business models, decision process and business execution in a rapidly changing world. All these developments have consequently imposed great expectations on the Board of Directors and senior management to provide the leadership and to balance judgment, but also to be forward looking in guiding the organization forward.

In today's business environment where competitiveness and sustainability is critical, a differentiating element that determine winners is not just having the value business propositions but also having the competent staff with right attitude and values, and perspectives. Of importance is the effective communication of the long-term aspirations and strategies to the staff and shareholders to contribute towards enhancing the strength of an organization for long-term growth. In the new environment, the focus of value creation has now moved from physical assets to intangibles. In the context of banking institutions in emerging economies, the development of a pool of best talents that provides the appropriate leadership and management skills for emerging market economies has to be accorded priority. In this regard, Bank Negara Malaysia has instituted measures for banking institutions to place emphasis on staff development and capacity-building to ensure the sustainability of performance of the banking institutions.

Ladies and Gentlemen,

Indeed, a strong culture of corporate governance goes beyond the independence and accountability of the board of directors and management, to the strengthening of regulatory enforcement. In many developed countries, there has been a significant reliance on self-policing and private disciplining measures in promoting good governance, particularly in the realm of accounting and audit practices. But questionable accounting practices and the major corporate failures that resulted have now raised serious questions on the need for more stringent regulatory oversight. The strategy in strengthening market discipline therefore requires a balance between prudential regulation, market discipline and shareholders' surveillance so as to promote long-term stability.

In a further endeavour to align boards of directors with shareholders, Bank Negara Malaysia is currently reviewing the corporate governance framework for banking institutions with the objective of placing greater emphasis on the role of independent directors, minimum qualifications of such directors and their compensation. In an environment where businesses would need to balance between the interests of various stakeholders, which could be conflicting at times, an appropriate framework for active checks and balance of governance is indeed crucial. In this

regard, the development of a competent set of independent directors would be a key factor. The challenge is in identifying outside directors who are sufficiently independent but knowledgeable to function as watchdogs for minority shareholders and other stakeholders. Independence reflects qualities of objectivity, experience, insight and force of character. The need for directors to possess this blend of knowledge and independence is critical, given the increased complexities of business activities and the rapid pace of changes in financial markets and practices. Getting the right balance of expertise and independence so that the board does not rubber-stamp the decisions of top management is indeed a major challenge.

Ladies and Gentlemen,

In Malaysia, the Government has been the main catalyst for corporate governance reform. Malaysia has essentially adopted a hybrid approach towards corporate governance reform that includes legal reform, self-regulation as well as undertaking measures to encourage market-based regulation. Malaysia has proceeded on the basis that there are aspects of corporate governance where statutory regulation is necessary and effective and others where self-regulation is more appropriate. The release of the Finance Committee Report on Corporate Governance in 1999 marked a new beginning of our concerted efforts towards enhancing the standards of corporate governance in Malaysia. It recognized that there is a crucial need to continue the process of building the necessary legal and institutional framework to support the development of good corporate governance practices within the capital and financial markets.

In this context, Bank Negara Malaysia has put in place measures to enhance the standards of corporate governance in the banking sector. The Banking and Financial Institutions Act 1989 provides the legal framework to amongst others protect the interest of shareholders, customers as well as provide the prudential framework to promote the stability of the financial system. Examples of the provisions in the Act include the maximum shareholding limit for individuals and corporations in banking institutions to avoid concentration of ownership. There is also restriction on extension of credit to related parties in order to avoid potential conflict of interest situation as well as setting up of limits on lending to a single customer. Other measures include the issuance of specific guidelines on the role and responsibilities of directors and the audit committee.

A Code of Conduct for Directors, Officers and Employees in Banking Industry has also been introduced to promote and maintain a uniform ethical standard so as to safeguard the integrity and credibility of the staff of the banking institutions. Minimum Internal Audit Standards with the aim to improve the quality of internal audit so as to provide the basis for guidance and measurement for performance of internal audit function and improve operational effectiveness of financial institutions, has also been put in place. The guideline also stipulates the main duties and responsibilities of internal auditors, scope of audit work, reporting and documentation of internal auditing as well highlighting the critical areas of operations which internal auditors should give due consideration. In addition to the above, to improve the level of transparency, minimum standards of disclosure in the financial statements has also been put in place and is continuously being reviewed to provide adequate and appropriate information on banking institution's risk profile, financial health and business performance to the public. The main objective of

these guidelines is to engender public confidence in banking institutions and to ensure that the management and board of directors exhibit integrity and professionalism in the running of the banking institutions.

Conclusion

The importance of sound corporate governance is clear. It is vital that all stakeholders, both public and private sector participants inculcate and instil a culture of good corporate behaviour. The responsibility for sound corporate governance must be a joint responsibility between the authorities, corporations, financial intermediaries, regulators and shareholders. While much effort has been made to put in place for a sound corporate governance framework, this alone would not suffice. The challenge here is in its application - to translate this into practice. For corporate governance to work, good corporate governance should be embedded in all aspects of the spectrum. Competition should not be seen as barrier to sharing knowledge and experience on issues of common interest for the betterment of the industry and economy at large. On that note I thank you for your attention.

CALENDAR OF EVENTS
January – March 2003

30 January 2003

Bank Negara Malaysia launched the "BankingInfo" Consumer Education Programme for the banking sector. The programme represents an important step forward in the modernisation of Malaysia's financial system and is one of the strategies of the Financial Sector Master Plan to enhance the consumer protection infrastructure.

6 February 2003

Bank Negara Malaysia issued commemorative coins in conjunction with the XIII Summit of the Non-Aligned Movement (NAM) that was held on 20-25 February 2003 in Kuala Lumpur.

26 March 2003

Bank Negara Malaysia released the 2002 Annual Report, which provides an analysis of the economic and monetary developments in 2002 and forecast for the Malaysian economy for the year 2003. It also contains the Bank's Annual Accounts as at the end of 2002.

26 March 2003

As part of the continuous effort to ensure availability of adequate funds at reasonable cost to the Small and Medium Enterprises (SMEs), Bank Negara Malaysia announced the provision of additional allocation of RM600 million for the Fund for Small and Medium Industries 2 (FSMI2) and RM400 million for the New Entrepreneurs Fund 2 (NEF2). Besides the Special Funds, several other initiatives have also been undertaken to enhance SMEs' access to financing, including injecting RM1 billion into the Credit Guarantee Corporation (CGC) to enhance its capacity to provide guarantees, and transforming ERF Sdn. Bhd. into a special purpose vehicle to provide financing and advisory services to Bumiputera SMEs.

26 March 2003

Bank Negara Malaysia announced further liberalisation of several exchange control rules, aimed at further improving the business environment in Malaysia by according greater flexibility to residents and non-residents in sourcing ringgit funds, in managing their foreign exchange exposure and improving overall operational efficiency.

26 March 2003

Bank Negara Malaysia announced the establishment of the International Centre for Leadership in Finance to provide a focused and coordinated approach towards human resource development for senior management in the financial sector. The Bank will allocate RM500 million as an endowment fund to establish the Centre.