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Bank Negara Malaysia Annual Report 2005

Malaysian Economy in 2005

Despite the high oil prices and the downturn in the global electronics cycle in the first half of the year, the Malaysian economy expanded by 5.3% in 2005. Economic growth was underpinned by supportive macroeconomic policies, strong expansion in global growth and favourable financial conditions. In 2005, the private sector remained the main driver of growth. The public sector, on the other hand, continued to consolidate its finances to more sustainable levels.

GDP by Expenditure Components (% change)

	2004	2005*p*	2006*f*
Gross Domestic Product	7.1	5.3	6.0
Private Expenditure[1]	13.1	9.5	7.4
Consumption	10.5	9.2	6.8
Investment	25.8	10.8	10.0
Public Expenditure[1]	-2.1	3.1	3.0
Consumption	6.0	5.9	3.2
Investment	-8.7	0.4	2.7
Net Exports of Goods & Services	-22.4	19.3	-5.4
Exports	16.3	8.4	8.9
Imports	20.7	7.6	10.0

[1] Exclude stocks

p preliminary *f* forecast

Despite concerns over the impact of high oil prices and uncertainty in the external outlook in the early part of the year, aggregate domestic demand recorded a strong growth rate of 7.3%. Private consumption continued to increase, supported by positive developments in the economy, namely, rising disposable incomes, the increase in job vacancies and the accommodative financing conditions. The higher fuel prices did not dampen private consumption activity as consumption levels were maintained with some moderation in savings, underscoring consumer confidence on income growth and positive outlook for the economy. In addition, the Government took active measures following the adjustment of administered prices to reinstate allowances to mitigate the increase in the cost of living and in reducing road taxes on smaller vehicles used by the lower-income group. As for private investment, concerns over the impact of high oil prices and the uncertain outlook for the economy was balanced by positive developments, particularly the upturn in the electronics cycle towards the end of the year as well as the sustained strength in domestic demand.

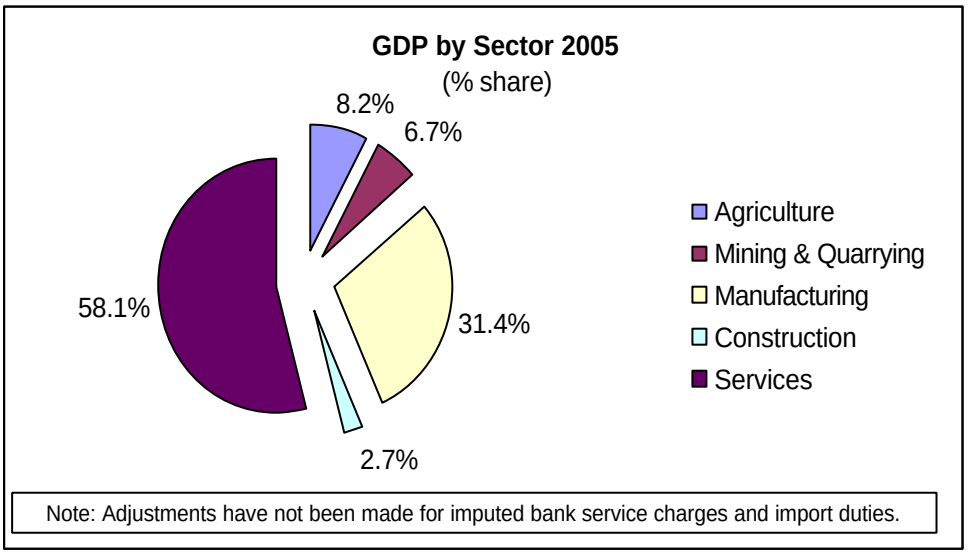
Bank Negara Malaysia's estimates indicated that the economy was on a balanced growth path in 2005. The output gap, or the difference between actual and potential output expressed as a percentage of the potential output level, remained small. Significantly, there has been an upward shift in productivity and a more rapid accumulation of capital as a result of the strong recovery in private investment, which would see the gap narrowing further in 2006.

GDP by Kind of Economic Activity (% change)

	2004	2005p	2006f
Real GDP	7.1	5.3	6.0
(RM billion)	249.0	262.0	277.6
Agriculture	5.0	2.1	2.0
Mining & Quarrying	3.9	0.8	5.0
Manufacturing	9.8	4.9	7.0
Construction	-1.5	-1.6	1.0
Services	6.8	6.5	6.0

p Preliminary
f Forecast

All sectors of the economy, with the exception of the construction sector, registered positive growth rates. While production growth in the manufacturing sector moderated in the first half-year as a result of the downturn in the global electronics cycle, it was partially offset by the strong growth in selected resource-based and domestic-oriented industries. In the second half-year, growth in the manufacturing sector gained momentum as the export-oriented industries regained its strength following the recovery of the global semiconductor sector while other major domestic industries continued to expand. The services sector continued to expand strongly in 2005, supported by the strong domestic demand, higher tourist arrivals and increased business activities.



The agriculture sector recorded a moderate increase primarily due to the weaker performance in the rubber, fisheries and paddy sub-sectors. Growth in the mining sector also moderated due to lower production of crude oil, although output for natural gas was substantially higher. The construction sector contracted for the second consecutive year, as civil engineering activities remained subdued. However, the residential and non-residential segments continued to expand due to resilient demand for houses and strong interest for office and retail space. In the residential sub-sector, sustained income growth and stable job prospects encouraged demand from households. In addition, the low interest rates and innovative financial products for property loans also supported this demand.

Inflation increased in response to the high global oil prices, but remained at manageable levels. While retail petrol prices had increased, it did not have disruptive effects on the cost structures of companies. At the same time, producers had partly absorbed some of the price increases due to competitive pressures, and thus moderated the increase in domestic prices. The cost-push increase in prices was mainly seen in the transport and communications category while core inflation remained relatively subdued at 2% (2004: 1%). Headline inflation, as measured by the annual change in the Consumer Price Index (CPI) stood at 3% for the year 2005. More importantly, higher energy prices also appeared to have intensified efforts towards greater energy efficiency and increased productivity in order to minimize costs. There was evidence of greater efficiency in terms of energy usage in the manufacturing sector, indicated by the downward trend in the energy intensity, as measured by energy consumption over sales. Labour market conditions remained stable with unemployment rate remaining low at 3.5%.

Inflation and Unemployment (%)

	2004	2005*p*
Inflation		
CPI (2000=1000)	1.4	3.0
Core CPI[1]	1.0	2.0
Unemployment	3.5	3.5

p Preliminary

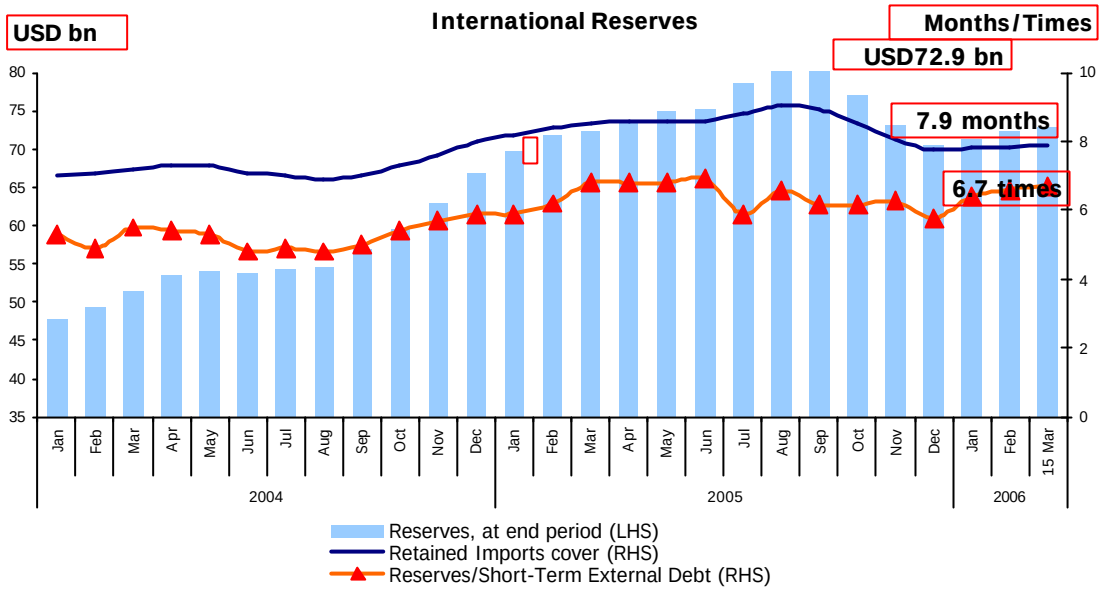
[1] Excludes price-controlled items and price-volatile items as well as items that are subject to one-off price adjustments

The overall balance of payments remained strong in 2005, supported by a larger current account surplus of RM77.8 billion, or 16.4% of GNP (2004: RM56.5 billion, or 13.3% of GNP). The larger current account surplus reflected stronger trade surplus of RM99.8 billion (2004: RM80.7 billion) as export growth was higher relative to imports. Exports grew at a more moderate pace of 11% in 2005 (2004: 20.8%) due mainly to a slowdown in manufactured exports which was affected by the softening of the IT sector at the beginning of the year, and a more moderate growth in agriculture exports. Nevertheless, exports of minerals remained strong supported by the higher energy

prices. Import growth moderated to 8.5% (2004: 26.4%), because of the slower growth in imports of intermediate goods due to the subdued performance of the electronics and electrical sector. The larger services account deficit was offset by an improvement in the income account deficit.

The financial account recorded a net outflow of RM42 billion in 2005 (2004: +RM15.1 billion), due mainly to a net outflow in portfolio investment, larger extension of trade credits by Malaysian exporters and larger repayment of external loans by the public sector. The outflow of portfolio investment reflected the exit of the funds that flowed in during 2004 and through the beginning of the year in anticipation of a change in the exchange rate regime and of a much larger appreciation of the ringgit arising from this change. The portfolio flows subsequently stabilised in an orderly price discovery process. On a gross basis, foreign direct investment (FDI) increased to RM25 billion (2004: RM23.5 billion), or 5.3% of GNP. The FDI inflows were seen mainly in the oil and gas, services and manufacturing sectors.

The current account surplus remained large enough to more than offset the net outflow in the financial account and the foreign exchange revaluation loss arising from the strengthening of the ringgit against the major currencies. As such, the international reserves increased by RM12.8 billion to RM266.3 billion or equivalent to USD70.5 billion at end 2005. As at 15 March 2006, the international reserves level rose further to RM275.2 billion or USD72.9 billion, adequate to finance 7.9 months of retained imports and is 6.7 times the short-term external debt.



Malaysia's external debt declined to RM195.9 billion in 2005 (2004: RM200.6 billion), reflecting mainly the higher repayment of external loans by both the Federal Government and the non-financial public enterprises (NFPEs). The repayments by the Federal Government marked the maturity of a Euro bond issued in 2000 and some scheduled principal repayments, while in the case of the NFPEs, the maturity of US dollar-denominated bonds as well as the prepayment of several loans. In contrast, the slight increase in short-term debt was due mainly to the banking sector assuming larger hedging activities on trade-related transactions. Malaysia's external debt position remains sustainable with the debt service ratio holding steady at 4.7% and its share of GNP declining to 41.4% (2004: 47.2%). Further, short-term debt remains small, accounting for only 23.6% of total external debt.

Macroeconomic Management in 2005

The macroeconomic conditions remained sound during the year with the current account in the balance of payments in surplus, high savings and reserves level while inflation remained at manageable levels. During the year, external debt also declined further. In addition, the Government continued its commitment to strengthen its budgetary position with the narrowing of its budgetary deficit from 4.3% of GDP in 2004 to 3.8% in 2005. The progressive reduction in the deficit enabled the Government to channel more resources for development.

Public policy during the year also focused on accelerating the shift towards higher value-added activities, developing new sources of growth and enhancing competitiveness. Efforts included measures to improve the delivery system and quality of services such as the establishment of customer service offices and one-stop centres, the launch of the National Biotechnology Policy (NBP) and the setting up of the Tax Review Panel. Further to this, the 2006 Budget includes incentives to develop new growth areas such as biotechnology, high technology manufacturing and ICT industries. These include the launch of the National Biofuel Policy to encourage private sector involvement in the production of biodiesel, the granting of Pioneer Status to selected companies undertaking ICT and multimedia services, which allows for tax exemption or tax allowances of up to 50% for five years, and the creation of Malaysian Life Sciences Capital Fund for investment in biotechnology with RM100 million contribution from the Government. Continued support was also given to developing the soft infrastructure by providing a larger allocation to education and training, focusing on developing skills to increase productivity and value added by the workforce.

The conduct of monetary policy in 2005 focused on balancing the risks to economic growth and inflation over the medium term. Over the course of the year, the risk of slower economic growth diminished, while the risks to inflation remained. Consequently, the Overnight Policy Rate (OPR) was then raised by 30 basis points to 3% on 30 November 2005 and by 25 basis points on 22 February 2006. At 3.25%, the OPR continues to remain below its neutral level. Monetary policy therefore continues to remain supportive of the economy.

With the aim to increase the effectiveness of monetary policy operations, Bank Negara Malaysia has, since January, actively utilised repurchase agreements (repo) as a monetary instrument, introduced the Institutional Securities Custodian Programme (ISCAP) to enable borrowing and lending of securities, and provided a securities lending facility for principal dealers. In addition, to promote greater transparency in matters related to monetary policy, the institutional framework for developing, implementing, and communicating monetary policy was further enhanced in December 2005. The Monetary Policy Committee (MPC) decided that the Monetary

Policy Statement (MPS) would be issued after every MPC Meeting. The MPS was previously issued four times a year. In addition, the schedule of MPC meetings for 2006 was also provided to the public, thereby allowing market participants to better understand Bank Negara Malaysia's monetary policy stance.

On 21 July 2005, Bank Negara Malaysia announced the change from a fixed exchange rate system to a managed float exchange rate regime. The ringgit's value is now monitored against a basket of the currencies of Malaysia's major trade partners. The continued strengthening of economic and financial conditions provided the conditions required to enable an efficient transition to the new arrangement. Following the floating of the ringgit, speculative portfolio positions that had been built-up in the first half of the year were unwound. The unwinding of these flows was orderly with no disruptions to the financial markets. The strong reserves level provided the cushion to adjust following these outflows, while the domestic financial system continued to operate in an environment of ample liquidity.

The change to the floating rate regime was also preceded by the setting up of the necessary risk management infrastructure to ensure a smooth transition. Rules on hedging were liberalised in April 2004 to allow both residents and non-residents to enter into hedging arrangements with licensed onshore banks. In addition, Bank Negara Malaysia had taken steps to further liberalise the foreign exchange administration rules in order to improve the delivery system and enhance flexibility in the financial system and the economy. Effective 1 April 2005, changes were made to give greater flexibility for overseas investments, including changing the thresholds for investments abroad, extension of credit facilities to non-residents and placement of funds by residents. Residents were also allowed to open foreign currency accounts onshore or offshore, without requiring the approval from the Central Bank. Similarly, the limits on foreign currency credit facilities obtained by residents were also increased.

Development of Small and Medium Enterprises (SMEs)

In 2005, the banking system approved RM35.8 billion of new loans to more than 85,000 SME accounts, representing an increase of 13.1% from 2004 (end-2004: RM31.6 billion; 92,000 SME accounts). Loan disbursements grew by 10.2% to RM110.7 billion, (end-2004: RM100.4b), while loans outstanding to SMEs expanded by 8.7% to RM96 billion (end-2004: RM88.3b). Loans to SMEs accounted for 42.6% of outstanding business loans as at end–2005, compared with 40.3% in 2004. Gross non-performing loans (NPLs) of SMEs declined marginally to RM10.2 billion and the gross NPLs ratio declined to 10.6% of total SME outstanding loans (end-2004: RM10.6 billion; 12%), reflecting an improvement in the financial position of SMEs. Due to strong demand, allocations for the Fund for Small and Medium Industries 2 and New Entrepreneurs Fund 2 were increased by RM250 million and RM350 million to RM4.75 billion and RM2.35 billion respectively in 2005. Hence, the total amount of the five special funds managed by Bank Negara Malaysia increased to RM8.9 billion.

The development of resilient and competitive SMEs was a major focus of Government policy. In this regard, the National SME Development Council has made significant progress in harnessing efforts to develop and promote resilient and competitive SMEs by introducing key initiatives focused on strengthening the enabling infrastructure for SME development, building the capacity and capability of SMEs and enhancing access to financing by SMEs. To enhance the formulation and coordination of SME policies and programmes, and the monitoring of the implementation and outcomes of the programmes, a Policy Formulation and Evaluation Framework was introduced in 2005. As the Secretariat to the National SME Development Council, Bank Negara Malaysia had an important role in developing the National SME Development Blueprint 2006 (Blueprint 2006). The Blueprint 2006 outlines the Government's objectives, targets and strategies, key programmes and financial commitment for SME development in 2006. In addition, the adoption of a common definition of SMEs and the completion of a Baseline Census to compile relevant data on the status of development and performance of SMEs would facilitate the identification of issues and the monitoring of the progress of SME development across all sectors. Further initiatives include the launch of the SMEinfo Portal and online training portal for SMEs, and the publication of

an Annual Report on SME development. To further enhance access to financing by SMEs, the SME Bank commenced operations on 3 October 2005 to provide financial and non-financial assistance to SMEs, including business and consultancy support services, such as advisory services and preparation of business plans.

Performance of the Banking System

The banking system remained resilient and sound throughout 2005 as evidenced by the encouraging performance of all key financial soundness indicators. The level of capitalisation remained sufficiently high amidst continued expansion in asset base, enabling the banking institutions to absorb the effects of several capital-related measures that were introduced during the year aimed at further enhancing the risk-sensitivity of the capital framework. The risk-weighted capital ratio (RWCR) and core capital ratio (CCR) remained strong throughout the year, standing at 13.1% and 10.2% respectively as at end-2005. Amidst sustained economic performance, the asset quality of the banking system improved further in 2005, as non-performing loans (NPLs) continued to decline. The improvement in loan quality was mainly attributed to higher reclassification of NPLs to performing status following overall improvement in the repayment capacity of borrowers and write-offs during the year. Meanwhile, the loan loss coverage ratios improved to 59.2% and 65.4% on the 3-month and 6-month basis respectively.

Gross operating profits for the year rose by 6.2% to RM13.1 billion, underscored by higher income from interest-related and fee-based activities. Despite competitive lending conditions, net interest income grew by 7.6% driven largely by the growth in interest income from loan and financing activities (+RM1.3 billion or 4%). The growth was, however, moderated by an increase in interest expense incurred during the year on deposits (+RM0.9 billion or 6.2%).

Banking Sytem Health[1]

	2004	2005*p*
Capital		
Core-capital ratio (%)	11.4	10.2
RWCR (%)	14.4	13.1
Net NPL ratio (%)		
6 months	5.8	4.6
3 months	7.5	5.8

p Preliminary
[1] Includes Islamic banks

The encouraging business and operating environment, improved financial positions and favourable economic outlook provided the impetus for banking institutions to continue to strengthen their balance sheets. During the year, the banking sector set aside loan loss provisions totalling RM11.4 billion. Notwithstanding this, the unaudited profit before tax of banking system increased by 7% to RM12.4 billion in 2005. As a result, return on average equity improved to 16.9%. Meanwhile, the return on average assets remained unchanged at 1.4% following a corresponding increase in total assets during the year.

Banking System[1] : Loan Indicators

	2004	2005	Annual growth (%)
	For the year (RM billion)		
Loan applications	273.3	305.4	11.7
Loan approvals	173.6	193.4	11.4
Loan disbursements	488.2	529.3	8.4
Loan repayments	461.6	489.2	6.0
Change in outstanding loans[2]	40.1	44.2	8.6

[1] Includes Islamic banks.
[2]The annual growth is for outstanding loan amount at end-period.

Lending activities of the banking system remained strong in 2005, supported by encouraging financing demand by both businesses and households. Strengthened resilience amidst favourable financial performance and improved asset quality had enabled the banking system to continue to support the expanded financing

requirements and thus, contributed towards the growth in business activity and private consumption. Lending to businesses remained resilient in 2005, with demand for new financing growing by 5.7% to RM158.5 billion (2004: 20%). Meanwhile, outstanding household loans expanded by 15.1% to RM304.4 billion, to account for 54.5% of outstanding loan portfolio of the banking system. In tandem with this increase, borrowings by household from the banking system increased to 61.5% of GDP as at end-2005. The level of indebtedness for the household sector, however, remained within prudential levels. The risk management infrastructure and capabilities of banking institutions have improved in recent years, thereby strengthening their capacity to manage risks emanating from their exposures to the household sector. To ensure sustainable debt exposures of the households, Bank Negara Malaysia will be establishing the Credit Counselling and Debt Management Agency (CCDMA) that will provide individuals with access to professional and expert assistance on debt and financial management.

Management of the Banking System

The main thrusts of policy measures in 2005 continued to focus on enhancing competitiveness of domestic banking institutions and preserving resilience of the financial sector. In this regard, efforts were focused on improving structural and operational efficiency of the banking institutions as well as introducing a more dynamic prudential regulatory framework and supervisory oversight and more effective and comprehensive surveillance infrastructure. Other key policy initiatives included ensuring continuous access to financing for all segments of the economy and strengthening the infrastructure for consumer protection and education. These initiatives reflected the broad thrust of Phase Two of the Financial Sector Masterplan (FSMP) to elevate the overall performance of the financial sector.

In 2005, the financial landscape continued to experience structural changes. All ten domestic banking groups have completed the rationalisation of their commercial banking and finance company businesses into a single entity. Another significant strategic initiative to further strengthen the capacity and capability of domestic banking

groups to contribute towards economic transformation and face challenges of liberalisation is the development of full-fledged investment banks via the mergers between merchant banks, stockbroking companies, and discount houses. The limit to foreign ownership in investment banks was also raised to 49%.

Progressive infusion of greater competition in the market acts as a catalyst towards performance improvement of domestic banking institutions. Towards this end, operational flexibility was accorded to locally incorporated foreign banking institutions (LIFBs) to establish up to four additional branches in 2006. This represents the first of a phased approach of branching liberalisation to allow greater participation of LIFBs in the financial sector. In addition, as part of efforts to provide banking institutions with greater flexibility and options in managing their exposures as well as allocating resources more efficiently and effectively, banking institutions were accorded the flexibility to sell outright their NPLs to eligible third parties or purchase NPLs from other banking institutions.

Due attention continued to be accorded towards ensuring that the fundamental elements of a safe and sound financial system remained intact. These include having a comprehensive and effective monitoring and surveillance framework, the presence of strong and dynamic prudential regulations and supervisory oversight, as well as having an efficient financial infrastructure and reliable financial safety nets. In the aspect of surveillance, efforts continued to be directed towards further enhancing the robustness of surveillance and assessment of institutional and systemic resilience.

In line with the move towards a 'principle-based' regulatory framework, greater responsibility is placed on the shareholders and board of banking institutions to ensure the sound and safe operations of their institutions. To steer the banking sector towards this objective, the corporate governance guidelines was revised to place greater emphasis on board oversight, the roles of independent directors and a clear separation between management and shareholders of banking institutions.

With respect to the implementation of Basel II in Malaysia, the feedback obtained from the industry indicates that most banking institutions did not foresee major problems

in adopting the standardised approach in 2008, beyond system enhancements. The results of the gap assessments conducted by banking institutions along with outcomes from bilateral discussions will be used as input in formulating the detailed supervisory guidance on the adoption of the different approaches under Basel II. In addition to the Basel II initiatives, efforts were ongoing in strengthening risk management practices of the industry. Towards this end, the implementation of the *Market Risk Capital Adequacy Framework (MRCAF),* effective April 2005, represented a significant shift towards explicit provision of regulatory capital for potential losses arising from activities that expose banking institutions to market risk.

As part of ongoing efforts to build the foundation for effective consumer protection, the Malaysia Deposit Insurance Corporation (MDIC) commenced operation in September 2005. The MDIC provides explicit protection of up to RM60,000 per depositor, per member institution. Additionally, to enhance interface with the public and as part of its corporate social responsibility, Bank Negara Malaysia LINK (*Laman Informasi Nasihat dan Khidmat*) was established as a one-stop reference point for the public, including individuals and SMEs, to seek information and clarification on related issues in addition to being a platform for consumer education.

The winding up of Pengurusan Danaharta Nasional Berhad (Danaharta) in December 2005 marked the successful completion of the final chapter in the financial sector restructuring effort undertaken in the aftermath of the Asian financial crisis. In total, the cost incurred by the Government for the financial sector restructuring efforts through Danaharta and Danamodal Nasional Berhad accounted for 2.5% of the nation's GDP.

In 2005, Bank Negara Malaysia intensified its efforts to develop and improve the payment systems infrastructure parallel to its objective of ensuring an efficient, reliable and secure payment systems. Initiatives included the setting up of a 'payment versus payment' mechanism to reduce inter-bank foreign exchange settlement risks and introducing a cheque truncation system to reduce the physical handling of cheques and other related costs. In enhancing the security of ATM and credit cards, banking

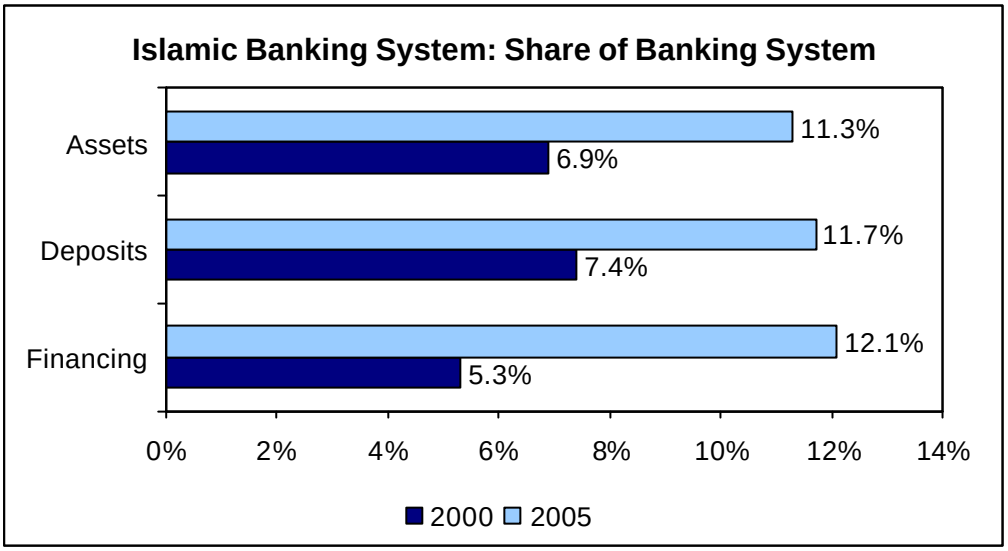
institutions have successfully completed the installation of chip-based terminals in 2005, making Malaysia the first in the region to complete a national chip migration exercise. The chip migration exercise was complemented with the implementation of line encryption to deter 'wire tapping' fraud, thus boosting the confidence of consumers, merchants and tourists in the use of payment cards in the country. In improving the access points for the remittance services, qualified non-banking institutions were allowed to offer remittance services, while banking institutions will be allowed to appoint collecting agents to facilitate their remittance transactions. To promote the migration to electronic payments, the Bank, in November 2005, held an extensive payment systems forum and exhibition, which provided a platform to discuss issues and challenges in migrating to electronic payments, and to increase public awareness on the various payment channels, products and innovation.

Islamic Financial System

The performance of the Islamic banking industry continued to strengthen during the year. As at end-2005, Islamic assets increased to RM111.8 billion, registering a strong growth of 17.7% and accounting for 11.3% of the total assets of the entire banking system. The market shares of Islamic deposits and financing also increased to 11.7% and 12.1% of the industry's total, respectively.

The Islamic financial system in Malaysia showed significant progress in an increasingly liberalised and competitive environment in line with the increased international integration of the Malaysian Islamic financial system. The institutional capacity and capability of the Islamic banking players as well as the financial infrastructure and regulatory framework were further strengthened to achieve the objectives as embodied in the second phase of the FSMP. The liberalisation of the Islamic banking industry saw the opening of the first foreign Islamic bank licensed under the Islamic Banking Act 1983 in August 2005. In addition, Islamic subsidiaries of three domestic banking groups have commenced operations to capitalise on the full extent of operational flexibility accorded by the Islamic banking licence. Following the liberalisation of the foreign exchange administration rules in 2004, greater market depth

was demonstrated in the Islamic financial market in 2005 as further ringgit-denominated Shariah-compliant financial instruments were raised in the domestic bond market by foreign agencies. This development not only boosted confidence in the domestic capital market but also contributed to strengthening the depth and breath of the market.



Bank Negara Malaysia continues to monitor the implementation of the Shariah governance framework following the issuance of the Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions (GPS1), which came into effect on 1 April 2005. In developing and promoting Shariah dynamism and convergence on the international front, Bank Negara Malaysia undertook two important initiatives in 2005. The first was the Shariah Scholars Dialogue held on 22 - 23 June 2005 in Kuala Lumpur and the second was the establishment of the RM200 million Fund for Shariah Scholars in Islamic Financ e.

In conjunction with the 30th Board of Governors Annual General Meeting of the Islamic Development Bank held in Malaysia, a seminar on the 10-Year Master Plan for Islamic Financial Services Industry to chart the roadmap for the Islamic financial services industry worldwide was held on 22 June 2005. It provided a platform to deliberate and set up the foundations for the development of a master plan that would

outline the blue print and strategic direction for sustained development of the global Islamic financial services industry.

With the development of a comprehensive Islamic financial system that is increasingly becoming more liberalised and integrated with the international financial system, Malaysia is well positioned to develop as an international Islamic financial centre. Initiatives are being directed at enhancing Malaysia's strength in the origination, issuance and trading of Islamic capital market and treasury instruments, Islamic fund and wealth management, offshore Islamic financial services market, and takaful and retakaful activities. To complement these initiatives are efforts targeted at making Malaysia as a centre of excellence in Islamic banking and finance education, training, consultancy and research. In addition, it is envisaged that the domestic Islamic banking institutions will continue to expand overseas to become regional Islamic financial players with the long-term objective of becoming global players. The policy direction will be to enhance the resilience, efficiency and capacity of the domestic Islamic financial institutions and the Islamic financial infrastructure with the aim of intensifying the robustness and stability of the Islamic financial system.

Development Financial Institutions (DFIs)

Total loans outstanding of the development financial institutions (DFIs) expanded by 25.8% to RM47.5 billion as at end-2005 (end-2004: RM37.7 billion). Loan growth was driven largely by the growth in financing for consumption credit and loans for infrastructure projects. Meanwhile, the extension of guarantee and credit insurance facilities rose by 12.4% to RM4.8 billion as at end-2005 (end-2004: RM4.3 billion), due largely to an increase in the guarantees provided by the Credit Guarantee Corporation Malaysia Berhad (CGC).

During the year, policy focused on two broad areas, namely, strengthening the DFIs' capacity and capability and enhancing the prudential framework to further strengthen the operations of the DFIs. The year 2005 marked a significant milestone in efforts to further strengthen the DFIs. The rationalisation exercise involving four DFIs, was completed during the year, and resulted in the establishment of the Bank

Perusahaan Kecil & Sederhana Malaysia Berhad (SME Bank) and the merger of the Export-Import Bank of Malaysia Berhad and Malaysia Export Credit Insurance Berhad. Meanwhile, Bank Pembangunan dan Infrastruktur Malaysia Berhad was restructured and renamed Bank Pembangunan Malaysia Berhad to reflect its new focus. The rationalisation exercise was an important initiative to realign the activities of the DFIs towards enhancing their strategic and business focus.

In addition, customised action plans were formulated for the SME Bank, Bank Pertanian Malaysia and the EXIM Bank, to enhance their effectiveness in providing advisory services to the SMEs. As part of efforts to improve its performance in carrying out its mandated role, initiatives were also introduced to strengthen the role of Bank Pertanian Malaysia in enhancing access to financing for the agriculture sector and agro-based industries. In ensuring that the operations of DFIs are carried out in a prudent, effective and efficient manner, Bank Negara Malaysia focused its efforts in enhancing the standard of corporate governance, risk management and operational efficiency in the DFIs.

Outlook and Prospects for the Malaysian Economy in 2006

Global economic expansion is expected to remain firm at 4.3% while the growth in world trade is projected to expand at a stronger rate of 7.4% in 2006. A more balanced global growth is expected across the major economies, with the recovery in Japan and Europe. Another notable feature is the stronger investment uptrend seen in several major economies while consumption remains robust. Growth in the East Asian region is expected to be sustained at a strong pace of 7~7.2%. The growth is also supported by the recovery in the electronics sector following higher ICT-related spending in the industrial economies and continued strength in domestic demand in the region. The latter will be driven by higher consumption of the significant young population that have high discretionary spending power and strong demand for consumer electronic products.

The Malaysian economy is expected to strengthen further in 2006 in an environment of more favourable global conditions. Real GDP is projected to grow at a

faster rate of 6%, driven by strengthening export performance and resilient domestic demand. The global semiconductor up-cycle, sustained global growth and higher prices for primary commodities are expected to have positive effects on exports, as well as private consumption and investment. Current indicators suggest that the upturn in the global semiconductor industry, which began in the second half of 2005, would gain momentum in 2006. Malaysia is expected to benefit from this favourable development with a stronger growth in manufactured exports, particularly in the computer and semiconductor segments. Domestic demand would be driven by private consumption as a result of rising income and demographic factors. The latter underscores the high propensity to consume of Malaysia's relatively large young working population. At the same time, in an environment of ample liquidity, credit conditions are expected to remain supportive. Private investment is expected to expand particularly in the manufacturing sector and the oil and gas industry, spurred by the favourable demand conditions.

On the supply side, growth in the manufacturing sector is expected to strengthen in line with the upturn in the global semiconductor cycle, while the services sector is expected to sustain its strong performance supported by higher trade-related activities, and continued increase in consumption and business activities. The commodities sector is expected to see a more broad-based growth, with improvement in the production of rubber, crude oil and the other agriculture segments, while crude palm oil output consolidates after three years of strong performance. The construction sector is expected to register a positive growth in line with the improvement in the civil engineering segment.

Cost-push inflation is expected to rise following the increase in the price of petroleum products on 28 February 2006. Strong demand could also provide some modest upward impetus to inflation. In the absence of further price adjustments, inflation is expected to peak in the first half of the year. Subsequently, inflation is likely to ease in the third quarter of 2006 following the lapse of the effects of price

adjustments that were implemented in 2005. For 2006 as a whole, the average rate of inflation is estimated to be in the range of 3.5% to 4%.

The balance of payments position is expected to remain strong in 2006 with a continued large current account surplus supported by a strong trade balance. The projected strong growth in exports, based on the continued expansion in manufactured exports, in particular exports of electronics and electrical products, will contribute to the surplus in the trade account. In addition, growth in commodity exports is expected to be sustained by high prices and increases in volume. In the financial account, steady inflows of foreign direct investment (FDI) would also strengthen the overall balance of payments. A large portion of the FDI would be in the form of reinvestments by the existing MNCs in Malaysia.

Economic, Monetary and Financial Management in 2006

Policies in 2006 focus on initiatives to generate greater quality growth in the near term to provide a strong foundation for long-term sustainable growth. These initiatives would include various measures to enhance national resilience and the ability to meet emerging external challenges, arising from rising oil prices and increasing global competition. The Federal Government's overall financial position is expected to strengthen further in 2006 as the economy regains its growth momentum. The fiscal deficit for the year is projected to reduce further to 3.6% of GDP (2005: 3.8%), after taking into account the potential net revenue loss of RM1 billion arising from tax measures announced in the 2006 Budget. The Federal Government's development expenditure would continue to focus on economic and social factors in its effort to reduce income disparities between rural and urban areas. At end-March 2006, the Government will be launching the Ninth Malaysia Plan (9MP), which sets out the foundation for further development and strengthening the prospects for the Malaysian economy for the period between 2006 and 2010. The Plan is expected to stress on the importance of ensuring further progress in the new growth areas in order to achieve the successful transformation of Malaysia into a more resilient knowledge-based economy.

On 22 February 2006, the OPR was raised by 25 basis points to 3.25% as the release of the fourth quarter GDP data indicated that the growth momentum was sustained at 5.2% while the underlying risks on inflation remained evident. Bank Negara Malaysia's monetary policy will continue to focus on maintaining a balance between the risks to price stability and economic growth. Monetary policy will therefore respond to new developments that have implications for the medium-term prospects of price stability and sustainable economic growth.

The thrust of policies for the financial sector in 2006 will be geared towards preserving the stability that has been sustained over the years by further strengthening institutional and systemic resilience and competitiveness, as well as promoting a conducive regulatory and supervisory environment. These efforts will be complemented by the ongoing consumer education and protection initiatives to ensure well-informed consumers and fair financial dealings. Emphasis would also continue to be accorded to further improving the efficiency of accessibility by various segments of the economy to financing.

With the completion of the harmonisation of regulations for investment banking, policy initiatives in 2006 will focus on the operationalisation of the investment banks framework. As new players are expected to emerge arising from the transformation of universal brokers and discount houses into investment banks, efforts will be directed towards assessing their capabilities to assume their new roles, whilst ensuring that the risks emanating from the integration of banking and capital market activities will be appropriately managed.

With growing complexity in the group structure of financial institutions, a second concept paper on the framework for consolidated supervision of financial conglomerates is expected to be issued in 2006. The more holistic approach in supervision will facilitate a more accurate assessment of a financial conglomerate's risk exposures and adequacy of risk management systems at the group level. This will be accompanied by initiatives to further strengthen the capability and capacity of supervisors in their oversight function.

Given the important relationship of the banking sector and the economy, efforts will be directed towards enhancing further the scope and depth of the surveillance framework by employing a broader range of forward-looking tools for monitoring and assessing developments in the financial and economic environment. At the same time, the stress testing framework will be enhanced to ensure its robustness in assessing the resilience of individual banking institutions to a broad range of economic and financial shocks.

For the payment systems, policy will be geared towards providing an enabling environment for more electronic payment methods to be introduced, promoting the use of formal payment channels and coordinating industry efforts in the migration to electronic payments. The efficiency in cheque processing will be improved by leveraging on the imaging technology to truncate cheques, thereby reducing the physical handling of cheques in the clearing process. At the same time, measures will be taken to improve the current electronic payment services to encourage greater use of these electronic payment channels. In addition, efforts will continue to be pursued in enhancing payment standards and establishing mechanisms to effectively mitigate payment risks. Recognising the importance of preserving consumer confidence in using Internet banking services, the Bank is revising the Internet banking guidelines to introduce new authentication requirements, together with greater consumer education and protection measures. Moving forward, the Bank will also be introducing electronic money regulations to regulate the issuance of multi-purpose electronic money by non-banking institutions. Efforts in the payments industry will be focus on increasing accessibility to payment services, improving service levels and promoting its active use. As Malaysia is a high user of cheques and cash, the potential cost saving in moving towards electronic technology in making payments is substantial.

In 2006, the major policy thrust for the Islamic banking sector will be to further strengthen the resilience of the Islamic banking system and expand the capacity and capability of the Islamic financial institutions. This is in line with the objective of enhancing the integration of the Islamic banking sector with the international Islamic financial landscape, and strengthening Malaysia's position as an international Islamic financial centre. The regulatory framework for the Islamic financial institutions (IFIs) will be strengthened following the issuance of the Islamic Financial Services Board's (IFSB) standards on capital adequacy and risk management to conform to the new requirements with effect from 1 January 2007. In addition, a framework on the governance of the investment account holders and revised guidelines on corporate governance for the IFIs will be introduced by Bank Negara Malaysia to further reinforce the institutional framework. Other areas of policy encompass the enhancement of the legal and Shariah framework, product and market development, and human capital development and consumer education.

The legal and regulatory framework is expected to be strengthened and the revised Islamic Banking Act 1983 will be tabled in 2006. Efforts will also be directed at meeting the manpower needs through the setting up of an International Centre for Education in Islamic Finance (INCEIF) in April 2006. Talent building is one of the key factors identified for the rapid development of innovation in Islamic banking products and services and INCEIF is expected to increase the pool of required talent in the global Islamic financial market. New policies and initiatives will also focus on making the Islamic financial services environment in Malaysia to be more conducive and investment-friendly to the international Islamic financial community. Efforts will be directed at promoting the use of Malaysia by external entities as the platform for their investment as well as financing needs.

The thrust of policy for the development financial institutions (DFIs) in 2006 is to further strengthen their capacity and capability, thereby nurturing and developing efficient, effective and robust institutions that are able to provide financial and non-financial support to the targeted sectors of the economy. With the completion of the rationalisation exercise involving four DFIs in 2005, initiatives going forward will focus on enhancing the functions and scope of activities of the DFIs in meeting the financial and developmental needs of their respective targeted sectors. Among others, these include strengthening the financial capacity of selected DFIs as well as broadening the range of products and services offered by them. Towards this end, further efforts will be undertaken to enhance the outreach and effectiveness of the advisory services provided by the DFIs to the SMEs, especially through collaboration with relevant Government agencies.

An important focus will be to enhance the regulatory environment to facilitate operations of the DFIs through customised prudential requirements and regulatory standards, as well as improving their financial soundness and risk management practices. Emphasis will also be accorded towards enhancing the efficiency of the DFIs. In this regard, initiatives will be undertaken to establish a comprehensive performance measurement framework for the DFIs, comprising both financial and non-financial performance indicators.

Bank Negara Malaysia's Audited Annual Accounts for 2005

Bank Negara Malaysia's financial position in 2005 has been examined and certified by the Auditor General. Total assets of the Central Bank rose to RM295.4 billion as at end-2005 (end-2004: RM284.9 billion). The major increase in assets was attributed to an increase in international reserves. Bank Negara Malaysia's international reserves increased to RM266.3 billion (US$70.5 billion) as at end-2005. The Central Bank registered a net profit of RM3.6 billion for the financial year ended 31 December 2005 and declared a dividend of RM1.2 billion to the Government for the year 2005.

Bank Negara Malaysia
22 March 2006