BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

Ref. No.: 11/07/12

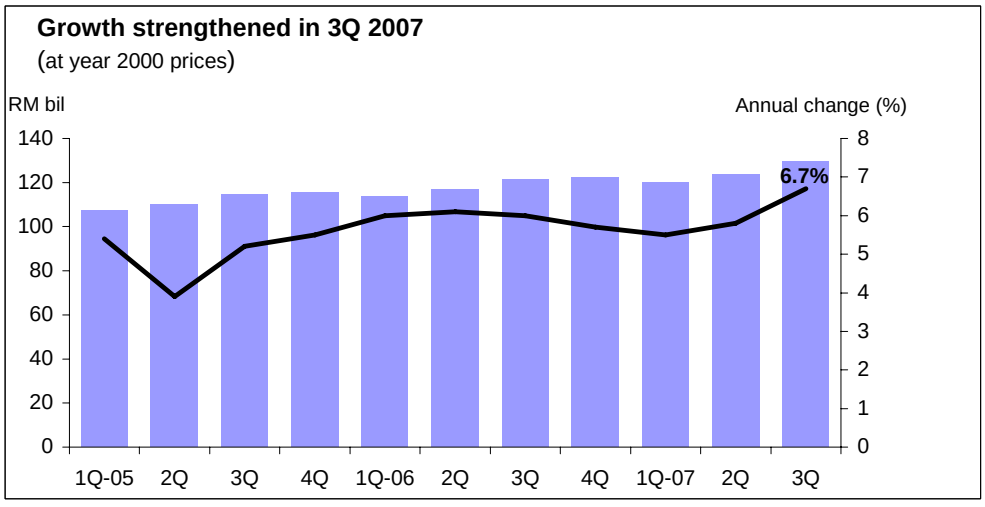
EMBARGO: Not for publication or broadcast before 1800 hours on Wednesday, 28 November 2007

ECONOMIC AND FINANCIAL DEVELOPMENTS IN MALAYSIA IN THE THIRD QUARTER OF 2007

OVERVIEW

Economy strengthened further in the third quarter

The Malaysian economy strengthened further in the third quarter of 2007. Sustained strong domestic demand raised real GDP growth to 6.7%. Domestic demand was supported by strong private consumption spending and investment activities. This was reinforced by increased public sector spending. On the supply side, growth was led by the services sector.



The expansion in the services sector accelerated to register a double-digit growth of 10.5% supported by strong domestic demand, tourism and business activities. Of significance, the finance, insurance, real estate and business services and the wholesale and retail trade, accommodation and restaurant sub-sectors performed well.

All other key sectors recorded positive growth in the third quarter. Growth in the manufacturing sector picked up to expand by 3.4% (2Q: 1.5%) reflecting a gradual recovery in the electronics and electrical (E&E) industry and further expansion in the domestic-oriented industries. Production of export-oriented industries expanded by 1.4% (2Q: -1.6%), supported by the turnaround in the E&E sector amidst the increased production of semiconductors mainly to meet the demand from the People's Republic of China and the European Union. In addition, the computers and parts segment which is closely linked to developments in the US market showed an improvement in the third quarter (0.2%; 2Q: -16.6%). Meanwhile, the domestic-oriented industries continued to expand by 4.6% (2Q: 8.6%) mainly supported by the sustained domestic construction activities and the upturn in sales of new motor vehicles following the release of new models.

The construction sector maintained its growth momentum, expanding by 4.7% in the third quarter of 2007 (2Q: 4.8%), mainly supported by the implementation of various infrastructure projects under the Ninth Malaysia Plan. The agriculture sector increased by 0.6% (2Q: -0.9%) following the gradual improvement in crude palm oil output, after the yield downcycle in the first half of the year. There was also a favourable performance in the minor agriculture activities such as vegetables, livestock and cocoa. The mining sector expanded by 2.3% (2Q: 7.7%) supported by the increase in crude oil output amidst the commencement of production of Malaysia's first deepwater oil field at Kikeh, Sabah in mid-August 2007. The production of natural gas, however, declined marginally due to lower external demand from Korea.

Domestic demand strengthened further in the third quarter to expand at an annual growth rate of 12.6% (2Q: 10.8%), on the strength of private sector activities. The increased public sector spending continued to provide support to growth. Private consumption expenditure registered a strong growth of 14% following rising disposable income supported by stable labour market conditions and strong commodity prices. The various promotions held during the nationwide Mega Sales Carnival from mid-June to early September had also encouraged higher household spending. Gross fixed capital formation also increased significantly by 13.5% in the third quarter (2Q: 6.6%) due to investment by both private and public sectors. Private investment indicators, namely loans approved and disbursed to the manufacturing and construction sectors trended firmly upwards suggesting greater momentum in capital spending by the private sector. Meanwhile, higher disbursement for development expenditure by the Federal Government was channelled towards high-multiplier impact economic activities in the form of projects for upgrading and construction of infrastructure to improve the transportation system as well as improving the provisions for the education services and the enhancement of the public utilities.

The headline inflation rate, as measured by the change in the Consumer Price Index (CPI) increased to 1.8% in the third quarter of 2007 (2Q: 1.5%), due mainly to higher prices for food and beverages.

On the external front, the trade account recorded a surplus of RM28.2 billion in the third quarter (2Q: RM22.6 billion). Gross exports slowed, with a marginal increase of 0.6% (2Q: 1.3%), led mainly by commodity exports, while exports of manufactured goods declined. Agriculture exports continued on an upward trend, driven mainly by palm oil exports due entirely to record high prices of RM2,599 per tonne following a rising global demand amidst lower production in Malaysia and Indonesia as well as lower supply of soybean oil and rapeseed oil in the United States and Europe, respectively. Mineral exports also expanded further during the quarter due to higher proceeds from exports of liquefied natural gas, which benefited from the rise in prices to a record high of RM1,226 per tonne. Meanwhile, manufacturing exports declined due mainly to the decline in exports of E&E products and selected resource-based industries. While there was an improvement in demand for E&E, the continued decline in prices affected exports of the E&E products during the quarter.

Growth of gross imports was sustained at 1.7%, reflecting the increase in investment and consumer spending. Imports of capital goods (excluding lumpy items) increased by 7.2% as capacity expansion in the manufacturing sector and upgrading for fuel efficiency led to the strong growth of imports of machinery, generators, turbines and electric motors. Imports of construction and mining equipment were also higher due to increased exploration activities in the oil and gas industry. Imports of consumption goods increased by 1% during the quarter (2Q: 1.1%) due mainly to higher imports of food and beverages for household consumption during the festive season. In line with the slowdown in exports of E&E, imports of intermediate goods declined by 1% during the quarter (2Q: +6.5%).

In the financial account, net inflow of foreign direct investment, as captured by Bank Negara Malaysia's Cash BOP System (not including retained earnings and investment in the form of imported machinery and equipment) amounted to RM6.8 billion in the third quarter (2Q: RM13.6 billion). The bulk of the investment was channelled into the services, manufacturing and oil and gas sectors. Overseas investment recorded a net outflow of RM6.9 billion (2Q: -RM8.5 billion). Meanwhile, portfolio investment recorded a net outflow of RM22.3 billion (2Q: +RM14.3 billion) on account of net liquidation of both equity and debt securities by foreign investors in July and August, following turbulence in the US sub-prime credit and mortgage lending markets. Inflows, however, resumed in September and October.

The international reserves of Bank Negara Malaysia amounted to RM335.4 billion (equivalent to USD98.2 billion) as at 28 September 2007. The reserves increased to RM345.3 billion (equivalent to USD101.2 billion) as at 15 November 2007. The reserves position is sufficient to finance 8.9 months of retained imports and is 7.4 times the short-term external debt.

Monetary policy remained supportive of economic activity

The OPR was left unchanged at 3.50% throughout the third quarter of 2007 as the prevailing level of the policy rate was consistent with the medium term outlook of relatively low inflation and sustained economic growth.

Reflecting the unchanged OPR, interbank rates for all maturities remained relatively stable during the quarter. In terms of lending rates, the average base lending (BLR) remained unchanged during the quarter, while the average lending rate (ALR) was considerably lower at end-September, largely reflecting the disbursement of lower priced syndicated bridging loans. Deposit rates remained relatively unchanged.

Financing to the private sector was higher in the third quarter, with banking system loans and PDS outstanding expanding at a higher combined annual rate of 8.9% at the end of the third quarter of 2007. Banking system loans outstanding increased at an annual growth rate of 9.5% at the end of the third quarter, with loans outstanding to businesses and households expanding at annual rates of 14.8% and 7.3% respectively. Loan applications, approvals and disbursements were also higher on an annual basis across the business and household sectors.

M3, or broad money, increased at an annual rate of 12.3% at the end of the third quarter (2Q: 12.6%). The expansion in M3 was driven mainly by higher claims on the private sector, on account of an expansion in bank credit and the holdings of private debt securities by the banking system.

Net funds raised in the capital market by the public and private sectors amounted to RM12 billion. This was lower than the RM22 billion raised in the previous quarter on account of a large PDS issuance in the previous quarter for merger and acquisition (M&A) activity. Net funds raised by the public sector amounted to RM13.4 billion, while net funds raised by the private sector through the private debt securities (PDS) market, excluding Cagamas, amounted to RM0.6 billion. Meanwhile, RM383 million in funds was raised through the equity market during the quarter (2Q: RM512 million).

In the light of the turmoil in the major financial markets arising from changing investor sentiments regarding losses related to the US subprime mortgages, most currencies, including the ringgit, experienced greater volatility during the quarter. At the beginning of July, the ringgit was on an appreciating trend amid trade and investment flows. Since 25 July, however, the ringgit depreciated against the major currencies following reversals by global investors out of debts and equities triggered by the international financial market turmoil during the period. Regional currencies were similarly affected by the reassessment of risks associated with emerging market assets by global investors. However, this trend reversed in both the ringgit and other regional currencies after the U.S. Federal Open Market Committee (FOMC) first reduced the discount rate on 17 August, and subsequently reduced both the Fed Funds rate and the discount rate by 50 basis points each on 18 September. The interest rate cuts and market expectations of further interest

rate reductions by the FOMC restored some degree of investor confidence. During the quarter as a whole, the ringgit strengthened against the US dollar by 1.1%. For the period 1 October – 27 November, the ringgit recorded a mixed performance against major and regional currencies.

Banking system continued to exhibit high resilience

The banking system continued to demonstrate a high resilience in the third quarter of 2007, supported by strong capitalisation, stable profitability and further improvements in loan quality. The risk-weighted capital ratio (RWCR) was sustained at 13.1% throughout the quarter, while the pre-tax profit remained firm at RM4.28 billion (2Q: RM4.32 billion). The level of non-performing loans (NPLs) continued to improve with the total net NPLs based on the 3-month classification declining by 8.6% to RM21.9 billion as at the end of the third quarter (2Q: RM24 billion). This was attributed primarily to higher recoveries and reclassifications of NPLs to performing status as well as continued write-offs. As a result, the net NPL ratio declined further to 3.5% of net total loans (2Q: 4.1%).

Growth momentum to continue in the near term

Despite increased risks of a sharp slowdown in the US economy, greater uncertainties in global financial market conditions and high oil prices, the global growth outlook remains supported by continued strength in the emerging economies, in particular, in the Asian region. Growth prospects for the large emerging economies, including China, India, Brazil and Russia, remain strong. In the domestic economy, forward looking indicators point to continued strong domestic demand in the near term. The latest six-month smoothed growth rate of the DOSM leading index was 7.4% in August. Consumers continued to remain optimistic on income and employment prospects as reflected in the MIER Consumer Sentiments Index, which rose to 117.5 points in the third quarter of 2007 (2Q: 115.9 points). The Business Conditions Index remained high at 117.5 points, reflecting sustained confidence in the corporate sector as underlying business activity continues to expand with the execution of more Ninth Malaysia Plan projects. Overall, given the strong domestic demand, the potential remains for the economy to continue on a steady growth path.

Bank Negara Malaysia
28 November 2007