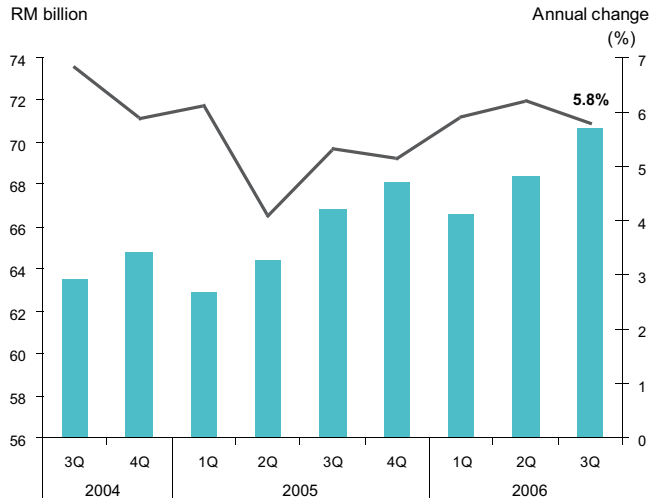
ECONOMIC AND FINANCIAL DEVELOPMENTS IN MALAYSIA IN THE THIRD QUARTER OF 2006

OVERVIEW

Growth momentum sustained

The Malaysian economy continued to remain on a steady growth path, with real gross domestic product expanding by 5.8% in the third quarter (2Q: 6.2%). Economic activity continued to be driven by the private sector. The services, manufacturing and agriculture sectors were the key contributors to growth during the quarter. The contribution to growth from the external sector was also stronger in the third quarter.

Steady GDP Growth in 3Q 2006



The services sector expanded at a strong pace of 6.5% during the quarter. The expansion was led by consumption, tourism, finance and trade-related activities. These activities supported stronger growth in the finance, insurance, real estate and business services; transport, storage and communication; and the utilities sub-sectors as well as sustained growth in the wholesale and retail trade, hotels and restaurants sub-sector. Value added growth in the manufacturing sector expanded by 7.1% (2Q: 8.4%), reflecting the expansion in both the export- and domestic-oriented industries. The export-oriented industries were mainly supported by growth in selected resource based industries. Meanwhile, the electronics and electrical (E&E) industry registered a growth of 5.4% during the quarter (2Q: 8.3%), supported by sustained growth in semiconductors and more moderate expansion in computers and computer peripherals. Strong growth in the fabricated metal products and food-related products industries and a turnaround in the construction-related materials industry contributed to the double-digit expansion in the domestic oriented industries.

Growth in the agriculture sector was stronger (6.2%), underpinned by a broad range of activities, including palm oil, rubber, paddy, fisheries, fruits and vegetables. Production in the mining sector, meanwhile, declined by 1.2% (2Q: -1.2%) due entirely to lower output of crude oil. In the construction sector, the decline was marginal (-0.4%) reflecting a more moderate contraction in civil engineering activities and renewed interest in the non-residential segment. At the same time, activity in the residential segment was supported by demand in prime locations.

The growth in consumption expenditure was sustained at 7.1% while private investment activities and increased public development spending supported the growth in gross fixed capital formation by 3.5%. The positive economic outlook and higher capacity utilisation in the manufacturing sector were among the factors accounting for the increased investment activity.

At the same time, Federal Government development expenditure increased with the bulk of the expenditure during the quarter being channelled into agriculture and rural development; education and public utilities.

Private consumption expenditure increased by 6.8% supported by stable labour market conditions, stronger export earnings and firm commodity prices. As expenditure on emoluments, supplies and services and defence was higher during the quarter, public consumption registered a stronger growth of 8.3%. Given the higher total expenditure during the quarter, the overall fiscal position turned to a deficit of 4.1% of GDP (2Q: +4.8% of GDP).

For the third quarter of 2006, headline inflation, as measured by the Consumer Price Index (CPI), moderated to 3.6% (2Q: 4.1%). The moderation was due mainly to the lower inflation for items in the *transport* category following the lapse of the upward revision in the prices of retail petrol and diesel that had taken place in August 2005. For the first nine months of the year, the headline inflation rate averaged 3.8% (2.9% during the corresponding period in 2005). This trend has continued in the fourth quarter with inflation moderating further to 3.1% in October. Labour market conditions continue to remain stable as job creation remained high and retrenchments declined significantly. Labour productivity in the manufacturing sector also turned around to record positive growth (0.7%).

On the external front, the trade surplus amounted to RM28.9 billion (2Q: RM22.9 billion) as growth in gross exports (13.6%) was higher relative to gross imports (11.5%). Growth in gross exports was led mainly by the stronger expansion in manufactured exports (14.2%) and agricultural exports (20.4%). The manufactured exports reflected increases in exports of E&E and resource-based products. Exports of E&E products expanded strongly by 10.3% (2Q: 5.6%). The agriculture exports reflected the sharp increase in palm oil (24.5%) and rubber exports (53%). The significant strength in rubber exports was on account of higher prices, while the robust performance of palm oil exports was due to higher volume (11.4%) and price (11.7%). Receipts from mineral exports increased by 1.3% on account of lower export volume of crude oil. The export price of crude oil remained high averaging USD72.18 per barrel in the third quarter and that of liquefied natural gas increased to an average of RM1,114 per tonne.

Gross imports remained strong, reflecting the increase in imported inputs for manufactured exports and domestic consumer spending. Growth in imports of intermediate goods (12.4%) and consumption goods (15.3%) was higher compared with the previous quarter. Imports of capital goods amounted to RM15.9 billion. Selected capital imports continued to record growth as capacity expansion and upgrading for fuel efficiency in the manufacturing sector was accelerated. This was most evident in the petrochemicals industry for which the growth in imports reflected the increased imports for machinery, generators, turbines and electric motors. Increased exploration activities in the oil and gas industry led to higher imports of construction and mining equipment.

In the financial account, foreign direct investment (FDI), as monitored by Bank Negara Malaysia's Cash BOP system, recorded a larger net inflow of RM5.4 billion. These inflows were broad based and channelled mainly into the manufacturing, oil and gas; as well as services sectors. This FDI data only captures new financial flows and does not include retained earnings that have been reinvested in Malaysia. It also does not include investment in the form of imported machinery and equipment. During the quarter, there was a net outflow of portfolio investment amounting to RM3.1 billion. For overseas investment, there was a net outflow of RM2 billion.

The international reserves of Bank Negara Malaysia amounted to RM293.1 billion (USD79.5 billion) as at 29 September 2006. As at 15 November 2006, the reserves

amounted to RM294.1 billion (USD79.8 billion), sufficient to finance 8.1 months of retained imports and was 6.7 times the short-term external debt.

Monetary policy remained supportive of economic activity

With inflation moderating and as available data point towards a sustained steady expansion in the domestic economy, the Overnight Policy Rate (OPR) was left unchanged at 3.50% throughout the third quarter.

The average quoted fixed deposit (FD) rates of commercial banks (CBs) remained relatively stable in the third quarter. As at the end of the quarter, the average FD rates ranged between 3.13% and 3.77%, for FDs with 1-month and 12-month maturities respectively (2Q: 3.11% and 3.77%). Of significance, the real average FD rates for the 6-month, 9-month and 12-month maturities have been positive since August as inflation moderated. Meanwhile, the average base lending rate (BLR) of CBs remained unchanged at 6.72%, while the average lending rate (ALR) peaked at 6.63% in July (end-2Q: 6.55%) and remained stable at that level for the remainder of the quarter. The average overnight interbank rate was close to the OPR for most of the quarter, except for a brief period in early September when several money market participants sourced funds in preparation for the Malaysian Government Securities (MGS) auction, which resulted in slightly higher rates.

Banking system loans and private debt securities (PDS) outstanding expanded at a combined annual rate of 7.9% at end-3Q (end-2Q: 9.1%). Banking system loans outstanding increased at an annual rate of 7.5%, with loans outstanding to businesses and households growing at 3.3% and 11.4% respectively (end-2Q: 4.2% and 13.3% respectively).

Gross funds raised from the PDS market amounted to RM9.2 billion during the third quarter (2Q: RM10.6 billion). The funds were mainly raised through the issuance of medium-term notes and long-term bonds. On a net basis, the funds raised through the PDS market, excluding Cagamas bonds, amounted to RM2.4 billion during the quarter (2Q: RM3.3 billion).

Both M1 and M3 expanded at a faster pace in the third quarter. M1, or narrow money, grew by 11.5% on annual basis (2Q: 10.1%), reflecting higher placements of demand deposits and currency held by the private sector. Meanwhile, M3, or broad money, increased at an annual rate of 7.9% (2Q: 6.4%).

Movements of the ringgit exchange rate continued to reflect market demand and supply conditions, as well as developments in the currencies of the regional and major industrialised economies. The ringgit depreciated against the US dollar during the quarter, as the US dollar was supported by safe-haven flows in reaction to geopolitical developments in the Middle East and North Korea, as well as some positive US economic data. The ringgit, however, appreciated against the Japanese yen as the Japanese currency weakened amidst reduced expectations for further interest rate increases. The ringgit depreciated against most regional currencies in the range of 0.4% - 6% during the third quarter.

During the period 1 October – 21 November 2006, the ringgit appreciated against most of the major currencies, amidst continued trade and investment flows. The ringgit also appreciated against most regional currencies in the range of 0.1% - 0.5%, the exception being against the Thai baht (1.6%) and Singapore dollar (0.9%).

The banking system remained strong

The banking system remained strong in the third quarter. As at end-September, the risk- weighted capital ratio (RWCR) improved to 13.2%. Pre-tax profits for the quarter amounted to RM3.8 billion. Net

interest income from stronger loans- and financing-related activities and net trading and investment income were higher. The level of non-performing loans (NPLs) of the banking system continued to improve as a reduced number of loans were classified as non-performing. As a result, the net NPL ratio reduced to 5.1% based on the 3-month classification.

Underlying growth momentum remains positive

Going forward, prospects for the global economy continue to be favourable. Despite the uncertainties on the growth momentum in the US, the direction of oil prices and the stance of monetary policy in the major industrial countries, the improved resilience of the global economy has produced less volatility in the international financial markets. Overall, global growth continues to be positive and broad-based. In the US, the economic slowdown during the quarter was primarily due to the significant decline in residential property investment and the high price effect of imported oil. The broader economy continues to remain resilient. Overall consumption spending and investment activity remained favourable, sustained by the stable labour market conditions, strong growth in non-residential property investment and high imports of both capital and consumer goods. In Japan, planned higher capital spending underscores the prevailing positive business sentiment and lends support for economic expansion to continue. In the euro area, the growth momentum is building and is expected to carry forward the expansion in economic activity. In the Asian economies the sustained strong performance would continue to provide support for mutually reinforcing growth as intra-regional trade and investment gains significance. In addition, the lower global oil price in the 3Q would have significant implications on the outlook for future inflation.

In the domestic economy, forward-looking indicators are also positive. The Business Conditions Index, Consumer Sentiments Index as well as the Employment Index continue to show an increasing trend thereby providing an indication of continued expansion in private investment activity and household consumption activities going forward. The latest six-month smoothed growth of the DOSM leading index was also close to 8%. This continued rise in the DOSM leading index over several months now suggests that growth in the Malaysian economy would be sustained into next year. Growth would continue to be driven by domestic demand, both by private sector and public sector activity and by the external sector amidst firm commodity prices. The contribution from the public sector reflects the continued disbursements of the development outlay with the acceleration in activity of the on-going projects and the progress in the implementation of the new high impact projects in education, agriculture, and rural development under the Ninth Malaysia Plan.

INTERNATIONAL ECONOMIC ENVIRONMENT

Mixed growth performance in the global economy

Global economic activity was mixed in the third quarter with moderating growth in the US, continued recovery in Europe and sustained expansion in the Asian region.

Following the cooling of the housing market, the **US** economy recorded a growth of 1.6% in the 3Q, largely due to the sharp decline in residential property investment (-17.4%). In addition, the less favourable trade performance continued to affect growth largely due to the high cost of imported oil. Nevertheless, the underlying strength of the broader US economy remained intact as overall consumption spending and investment activity remained favourable, sustained by the more favourable labour market conditions and the strong growth in non-residential property investment, as well as high imports of capital and consumer goods. In **Japan**, the economy continued to expand by 2.0% in the 3Q. Exports provided more support to the growth, against the background of sustained demand from People's Republic of China (PR China) and the US, while capital spending increased by 2.9%. Positive business sentiment has also been a contributory factor with big manufacturers planning to increase capital spending, as reported in the latest Tankan survey. The **euro area** economy sustained its growth momentum at 2.6% in the 3Q, driven mainly by strong exports and domestic demand. The economy remained on a steady course as the PMI index improved in October. Meanwhile, Germany's 3Q GDP growth was more broad-based with contributions from both domestic and foreign demand. Similarly in the **United Kingdom (UK)**, GDP for 3Q expanded by 2.8%, mainly supported by expansion in the services and manufacturing sectors. Meanwhile, rising housing prices and buoyant stock markets continued to underpin consumer confidence in October.

The need for **monetary policy** tightening became less for several countries in the global economy. In the US, with future inflation risks expected to abate, following the moderating economic performance and the decline in oil prices, the Federal Open Market Committee (FOMC) maintained the Fed funds rate at 5.25% for the third consecutive time on 25 October. The **Bank of Japan** maintained the uncollateralised overnight call rate at 0.25% on 31 October, after ending its zero interest rate policy in July. The **European Central Bank** continued to increase its key refinancing rate by 25 bps to 3.25% on 5 October, due to upside risks to price stability following strong money and credit growth in the economy. The **Bank of England** increased its interest rate to 5% on 9 November, which is the highest level recorded in five years.

Global **crude oil prices** averaged USD71 per barrel for the quarter. After having peaked at USD78.40 on 14 July, oil prices have declined. In October, crude oil prices experienced the biggest correction in over 15 years, falling by nearly 20% from its mid-July peak to hover around USD58–61 p/b. The decline

Industrial countries: Real GDP Growth

	2005		2006			Key contributing factors for 3Q growth
	3Q	4Q	1Q	2Q	3Q	
	Annual change (%)					
US[1]	4.2	1.8	5.6	2.6	1.6[a]	Slower growth following decline in residential property investment and a larger trade deficit. Nevertheless, private consumption, non-residential property investment and government spending remained positive.
UK	1.8	1.9	2.3	2.6	2.8	Stronger growth supported by an expansion in the services sector and manufacturing production.
Euro zone	1.7	1.8	2.2[r]	2.7[r]	2.6[p]	Sustained growth supported by both domestic and foreign demand, particularly in Germany.
Japan[1]	2.0[r]	4.1[r]	3.2[r]	1.5[r]	2.0[p]	Steady recovery following rebound in residential property investment while exports continued to underpin growth in the 3Q. However, private consumption recorded a decline.

[1] Annualised basis
[a] Advance estimates
[r] Revised
[p] Preliminary

Source: National authorities

in prices was supported by easing geopolitical concerns, rising inventories, the milder-than-expected hurricane season in the US and expectations of moderating demand following the slowdown in the US economy.

In the **Asian region**, economic growth was sustained in the third quarter, albeit at a slower pace, compared to the second quarter. Growth was supported by strong performance in PR China, recovery in the electronics sector amid strengthening of domestic demand. Regional exports remained resilient, performing better than initial expectations despite concerns of a potential slowdown in US demand.

Inflation rates in most regional countries showed a downward trend. Of significance, in Thailand, inflationary pressures began to subside, reflecting the fading effect of the floating of diesel price in late June 2006 and the lower energy, transportation and communication prices. In terms of **monetary policy** stance, India, Korea and PR China have raised interest rates during the quarter while Singapore reaffirmed its policy of a 'modest and gradual appreciation' of the Singapore dollar nominal effective exchange rate (S$NEER) policy band. Meanwhile, Indonesia continued to lower rates in early November.

In the **foreign exchange market**, the dollar weakened against most major currencies during the quarter. The depreciation of the dollar was driven mainly by increased expectations of an end to the tightening US monetary policy stance. The Japanese Yen and Swiss franc were two exceptions as both currencies depreciated due to carry-trade activities. Yen slipped to an all-time low against the euro on 19 September. Meanwhile, the performance of regional currencies was generally mixed. The Philippine peso, Thai baht, Chinese yuan, Indonesian rupiah and Korean won strengthened during the third quarter compared to the end of the second quarter, while the other regional currencies weakened slightly. The peso recorded the strongest appreciation, buoyed by positive economic data and remittances from overseas workers.

Regional Countries: Real GDP Growth

	2005		2006			Key contributing factors for 3Q growth
	3Q	4Q	1Q	2Q	3Q	
	Annual change (%)					
PR China	9.8	9.9	10.3	11.3	10.4	Driven by investment and exports.
Singapore	7.6	8.7	10.7	8.2	7.2	Supported by manufacturing and the wholesale and retail trade sector.
Hong Kong	8.2	7.5	8.0	5.5	6.8	Supported by investment and exports.
Indonesia	5.6	4.9	4.8	5.1	5.5	Supported by private consumption and net exports.
Korea	4.5	5.3	6.1	5.3	4.6	Supported by government consumption and facility investment.

Source: National authorities

DEVELOPMENTS IN THE MALAYSIAN ECONOMY

Sustained growth momentum reflecting underlying strength in the economy

Real GDP expanded by 5.8% (2Q: 6.2%) in the third quarter of 2006, indicating underlying strength in the economy. The growth was supported by sustained growth in the services and manufacturing sectors, and higher growth in the agriculture sector. Growth in the manufacturing sector was reflected by expansion in export-oriented industries and improvement in the domestic-oriented industries. Meanwhile, growth in the services sector was broad based, supported by continued consumer demand, tourism, finance and trade-related activities. Similarly, growth in the agriculture sector was supported by a wide range of activities, including the key industrial crops such as palm oil and rubber as well as food-based commodities such as paddy, fish, fruits and vegetables, induced by weather-related factors and attractive commodity prices. Construction activity remained stable, while the mining sector declined due to lower crude oil production.

Quarterly GDP by Kind of Economic Activity at 1987 Prices

	2005		2006		
	3Q	4Q	1Q	2Q	3Q
	Annual Change (%)				
Agriculture	1.7	-1.5	7.4	5.6	6.2
Mining	3.4	-2.0	-1.3	-1.2	-1.2
Manufacturing	3.5	7.9	8.5	8.4	7.1
Construction	-1.4	-0.6	-1.8	-0.5	-0.4
Services	7.3	5.9	5.9	6.6	6.5
Real GDP (Ann. Chg.)	**5.3**	**5.2**	**5.9**	**6.2**	**5.8**
Real GDP (Preceding Chg.)	**3.8**	**1.8**	**-2.2**	**2.7**	**3.3**

Source: Department of Statistics, Malaysia

Sustained strength in services activities

The services sector continued to expand at a strong pace of 6.5% (2Q: 6.6%) propelled by domestic consumption, tourism, finance and trade-related activities resulting in a broad-based expansion across the sub-sectors.

Of significance, growth in the **finance, insurance, real estate and business services** sub-sector picked up to 7.5% (2Q: 6.7%) during the quarter. Both conventional and Islamic banking activity remained strong supported by lending and fee-based activities, while insurance activities picked up strongly mainly supported by investment-linked products. Growth was further augmented by real estate and business services activities, including IT-related services, benefiting from the 66 new MSC-status companies coming into operation during the quarter (2Q: 30), including 5 shared services and outsourcing (SSO) companies (2Q: 11).

The **wholesale and retail trade, hotels and restaurants** sub-sector grew by 5.8% (2Q: 6.5%) reflecting continued support from domestic spending amidst the increase in consumer sentiment during the quarter. Activities in the distributive trade sector, other than the motor vehicle segment, was supported by the Mega Sales Carnival held during the period 22 July–3 September, and also by the preparations for the up-coming major festivals in the final quarter of the year. Pick-up in tourism activities, particularly tourists from the Middle East during their summer vacation months further supported the retail and hospitality segments, particularly in the main cities and tourist areas. The distributive trade activities in the motor vehicle segment, however, remained sluggish, due to weak demand for new vehicles which was affected by the low trade-in value of second-hand vehicles.

Growth in the **transport, storage and communication** sub-sector trended higher to 7.1% (2Q: 6.7%) mainly reflecting better performance in the transportation segment, and sustained growth in the telecommunication segment. The transportation industry benefited from higher trade and port-related activities. Growth in the telecommunications industry was sustained at a strong pace driven by increased demand from IT-related services, including SSO, as well as increased subscriber base for the

cellular and broadband segments and higher usage of data and voice services in the cellular segment.

Performance in the Services Sector (Value Added)

	Share 2005	2005		2006		
		3Q	4Q	1Q	2Q	3Q
	%	Annual change (%)				
Intermediate Services	**41.5**	**5.9**	**5.5**	**5.4**	**6.7**	**7.4**
Transport, storage & communication	15.1	4.3	4.9	4.5	6.7	7.1
Finance, insurance, real estate & business services	26.4	6.9	5.8	6.0	6.7	7.5
Final Services	**58.5**	**8.2**	**6.1**	**6.2**	**6.5**	**5.8**
Electricity, gas & water	7.1	6.5	3.7	4.2	3.4	5.2
Wholesale & retail trade, hotels & restaurants	25.2	9.9	7.0	6.1	6.5	5.8
Government services	12.8	9.0	7.4	9.3	10.4	7.9
Other services	13.3	5.4	4.6	4.6	4.5	4.2
Total Services	**100**	**7.3**	**5.9**	**5.9**	**6.6**	**6.5**

Source: Department of Statistics, Malaysia

The **utilities** sub-sector recorded a higher growth of 5.2% (2Q: 3.4%), due to higher electricity generation supported mainly by increased demand from the commercial segment due to the World Cup event and extended retail hours during the Mega Sales carnival which took place during the quarter. The **Government services** sub-sector was supported by increases in emoluments and allowances paid, in addition to the bonuses accrued to the civil servants.

Selected Quarterly Indicators in the Services Sector

	2005		2006		
	3Q	4Q	1Q	2Q	3Q
	Percentage at end-period (%)				
Cellular phone penetration rate	66.8	74.1	77.7	80.8	81.6
Internet subscribers penetration rate	13.8	13.9	13.9	14.0	14.0
Broadband subscribers penetration rate	1.7	1.9	2.2	2.5	2.8
	Annual change (%)				
Total passenger traffic at all airports	5.6	1.9	6.5	2.8	-0.03
Total consumption credit outstanding	18.6	18.7	18.8	21.0	17.0
Loan outstanding to the wholesale & retail trade, hotels & restaurants	12.6	8.3	7.3	9.0	11.5
Imports of consumption goods	5.2	4.2	14.0	12.8	15.3
Total sales of passenger cars	1.5	13.6	-9.5	-6.2	-7.0
Total sales of commercial vehicles	50.2	16.5	25.2	-10.2	-15.0
SMS traffic	143.3	156.3	118.9	53.4	36.6
Total cargo handled at all airports	0.6	6.2	10.7	6.0	4.9
Container cargo handled (Port Klang and PTP)	5.2	7.8	7.8	13.9	15.7

Source: Various sources

Manufacturing sector continued to expand

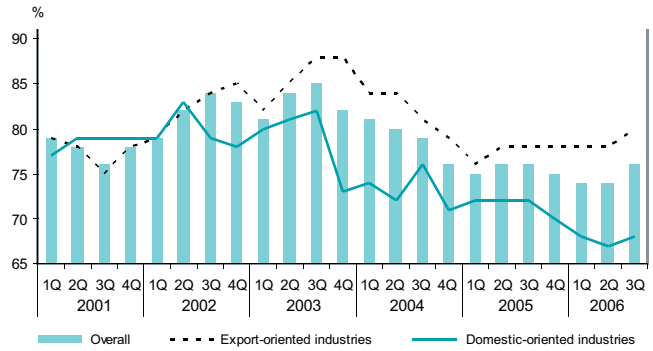
Value-added growth in the **manufacturing sector** expanded by 7.1% (2Q: 8.4%), reflecting the expansion in export-oriented industries and further improvement in domestic-oriented industries. The overall capacity utilisation rate of the manufacturing sector averaged at 76% during the quarter (2Q: 74%), with the export-oriented and domestic-oriented industries operating at 80% and 68% respectively (2Q: 78% and 67% respectively).

In the **export-oriented industries,** the growth of 6.3% (2Q: 9.6%), was mainly supported by selected resource-based industries. Meanwhile, the E&E industry registered a growth of 5.4% during the quarter (2Q: 8.3%) reflecting sustained growth in semiconductors and a more moderate growth in computers and computer peripherals. Among the resource-based industries, output of rubber products grew at a stronger pace of 13.9% (2Q: 8.6%), supported by the strong external demand for rubber gloves, which more than offset the sluggish performance in the tyre segment due to the ongoing conversion to higher value-added products. In addition, the petroleum products and the off-estate processing industries increased by 18.5% (2Q: 15.5%) and 10% (2Q: 7.2%) respectively. The latter was in line with the upward trend in output of primary commodities such as crude palm oil and rubber.

At the same time, the **domestic-oriented industries** showed a discernable improvement during the quarter, increasing at a double-digit growth of 12.1% (2Q: 5.3%), as a result of the combined effects of the turnaround in construction-related materials industry (8%; 2Q: -0.6%) as well

as the robustness of the fabricated metal products (35.9%; 2Q: 24.4%) and food-related products industries (15.3%; 2Q: 3.7%). The strong growth rates in these industries more than offset the contraction in transport equipment industry (-4.3%; 2Q: 3.9%) which continued to be affected by the lackluster demand for new passenger cars. The output of glass and metal products was supported by both domestic and external demand, while the food and beverage sectors showed a significant growth as manufacturers prepared for year-end festivities.

Capacity Utilisation in the Manufacturing Sector



Performance in the Manufacturing Sector

	2005		2006		
	3Q	4Q	1Q	2Q	3Q
	Annual change (%)				
Value Added (Constant Price)	**3.5**	**7.9**	**8.5**	**8.4**	**7.1**
Overall Production	**4.7**	**8.2**	**8.9**	**8.7**	**7.4**
Export-oriented industries	**5.7**	**10.1**	**10.8**	**9.6**	**6.3**
Of which:					
Electronics and electrical	3.3	10.5	17.3	8.3	5.4
Chemicals and chemical products	13.1	16.8	5.6	10.8	-1.4
Petroleum products[1]	10.8	11.5	8.7	15.5	18.5
Textiles, wearing apparel & footwear	12.7	10.3	10.6	14.5	1.9
Wood and wood products [2]	1.4	3.1	3.3	-1.3	4.5
Rubber products	-4.0	-1.6	-7.3	8.6	13.9
Off-estate processing	2.0	-4.6	-4.9	7.2	10.0
Domestic-oriented industries	**0.7**	**0.4**	**1.1**	**5.3**	**12.1**
Of which:					
Non-metallic mineral products	-1.6	1.5	-5.1	1.2	7.9
Iron & steel and non-ferrous metal	-7.1	-13.4	-9.8	-4.1	8.2
Food	7.7	4.8	-1.6	3.7	15.3
Transport equipment	6.5	6.7	6.6	3.9	-4.3
Fabricated metal products	-5.6	-5.7	15.2	24.4	35.9
Total Manufactured Exports	**6.3**	**13.1**	**10.6**	**10.0**	**14.2**
Of which:					
Electronics and electrical products	6.8	14.7	8.4	5.6	10.3
Chemical and chemical products	1.3	4.5	-6.9	9.9	22.4
Petroleum products	19.4	20.6	40.3	39.0	31.8
Optical & scientific equipment	-0.7	12.4	7.9	5.2	24.3
Wood and wood products	-14.9	6.6	-3.7	10.0	34.3
Furniture & parts	3.0	0.8	8.0	5.4	10.5
Rubber products	10.0	18.7	17.7	38.4	46.3

[1] Under the new Industrial Production Index (2000=100), LNG has been reclassified as petroleum products (previously classified as chemicals and chemical products). Consequently, petroleum products have been reclassified as export-oriented industries.
[2] Output of furniture and parts are not captured in the wood production data.

Source: Department of Statistics, Malaysia

Broad based strengthening in agriculture, while the mining sector declined

The agriculture sector continued on its strong growth momentum for the third consecutive quarter, rising by 6.2% (1Q: 7.4%; 2Q: 5.6%), underpinned by a wide range of activities including palm oil, rubber, paddy, fisheries, fruits and vegetables. The mining sector, meanwhile, declined by 1.2% (2Q: -1.2%) due entirely to lower output of crude oil.

In the **agriculture sector, crude palm oil production** reached a new high of 4.52 million tonnes during the quarter, surpassing the previous peak of 4.09 million tonnes recorded in the corresponding period of 2004. The strong expansion of 10.6% (2Q: 7.4%) was largely due to an encouraging rise in yields of fresh fruit bunches (FFB) at 5.66 tonnes per hectare (2Q: 5.14 tonnes per hectare) induced by the favourable weather conditions which accelerated harvesting activities. Similarly, output of **natural rubber** strengthened further to record higher growth of 8.1% (2Q: 7.6%), as rubber prices, while levelling off from the record high of 895 sen per kilogramme seen in the first week of July 2006, continued to remain attractive, averaging 760 sen per kilogramme. The high prices have motivated increased tapping activities, especially among smallholders who dominate the sector, to use modern technologicies such as Low Intensity Tapping System (LITS) to raise yields.

Performance in the Agriculture Sector

	2005		2006		
	3Q	4Q	1Q	2Q	3Q
	Annual change (%)				
Value Added (at 1987 prices)	**1.7**	**-1.5**	**7.4**	**5.6**	**6.2**
Production[1]					
Of which:					
Crude palm oil	0.2	-6.0	-5.4	7.4	10.6
Crude palm kernel oil	7.8	-5.4	-8.9	6.7	11.5
Rubber	4.4	-3.8	24.7	7.6	8.1
Fish	-5.6	-1.7	8.0	9.3	5.9
Livestock	4.4	30.4	22.7	16.9	9.8
Cocoa	-19.0	-7.8	24.1	52.4	17.8
Exports (RM million)	**-0.1**	**3.2**	**4.5**	**3.3**	**20.4**
Of which:					
Palm oil					
('000 tonnes)	4.0	-0.2	2.7	-4.9	11.4
(RM/tonne)	-13.5	-8.2	-4.6	1.0	11.7
(RM million)	-10.0	-8.4	-2.0	-4.0	24.5
Palm kernel oil					
('000 tonnes)	-14.3	-2.1	-45.8	-23.3	58.7
(RM/tonne)	-5.8	-12.4	-12.4	-19.6	-10.1
(RM million)	-19.2	-14.2	-52.6	-38.3	42.7
Rubber					
('000 tonnes)	4.4	-0.2	3.0	5.1	-4.1
(Sen/kilogramme)	13.0	28.7	43.9	53.9	59.5
(RM million)	18.0	28.4	48.2	61.7	53.0
Sawn timber					
('000 cu.metres)	9.1	-0.8	-19.6	-15.1	-8.0
(RM/cu.metre)	5.7	23.5	37.2	17.6	11.1
(RM million)	15.3	22.4	10.3	-0.1	2.2
Saw logs					
('000 cu.metres)	-4.4	1.6	-19.4	-23.0	-21.6
(RM/cu.metre)	14.7	17.0	18.1	9.9	7.7
(RM million)	9.7	18.8	-4.8	-15.4	-15.6
Cocoa beans					
('000 tonnes)	-77.6	-5.6	101.1	1.6	321.3
(RM/tonne)	18.6	3.5	0.1	1.4	4.4
(RM million)	-73.4	-2.3	101.2	3.1	339.8

[1] In '000 tonnes, except for saw logs in '000 cubic metres and livestock in numbers slaughtered (Peninsular Malaysia only)

Source: Malaysian Palm Oil Board (MPOB)
Malaysian Rubber Board (MRB)
Fisheries Department, Malaysia
Malaysian Cocoa Board (MCB)
Veterinary Services Department, Malaysia
Department of Statistics, Malaysia

Growth was also experienced in the 'other agriculture' subsectors, particularly paddy, fish, fruits, vegetables and cocoa. Output of **fish** rose by 5.9% to 403,317 tonnes, due mainly to increase in marine landings, while **fruits, vegetables** and **paddy** output increase was supported by weather-related factors.

Performance in the Mining Sector

	2005		2006		
	3Q	4Q	1Q	2Q	3Q
	Annual change (%)				
Value Added (at 1987 prices)	**3.4**	**-2.0**	**-1.3**	**-1.2**	**-1.2**
Production					
Of which:					
Crude oil and condensates	-5.7	-6.1	1.9	0.2	-3.5
('000 barrels)					
Natural gas (net)	15.9	-0.6	-6.0	-3.0	3.5
(million standard cubic feet)					
Exports (RM million)	**25.8**	**20.2**	**23.0**	**10.1**	**1.3**
Of which:					
Crude oil and condensates					
('000 tonnes)	-9.4	8.6	-7.3	-5.3	-15.8
(USD/barrel)	43.6	26.3	40.8	31.0	16.9
(RM million)	29.0	36.3	28.1	19.2	-4.1
Liquefied natural gas					
('000 tonnes)	5.7	-1.7	-2.6	-8.5	1.8
(RM/tonnes)	16.8	17.6	19.6	15.2	13.0
(RM million)	23.4	15.5	16.4	5.4	15.0

Source: PETRONAS
Department of Statistics, Malaysia

Cocoa production strengthened again for the third straight quarter by 17.8% to 4,683 tonnes, due to fewer incidences of the black pod infection.

The **mining sector** was affected by the lower production of crude oil, while the production of natural gas rose during the quarter. Output of crude oil (including condensates) fell by 3.5% to 695,289 barrels per day (2Q: +0.2% to 657,423 bpd), due to a scheduled shutdown of an oil field for maintenance purpose. Meanwhile, production of natural gas rose by 3.5% to 5,550 million standard cubic feet per day (2Q: -3%) supported by higher external demand from the major importing countries.

Construction activity remained stable

Construction activity remained stable during the quarter, with the sector registering a mild decline of 0.4%. The performance was reflected by a more modest contraction in the civil engineering sub-sector. Activity in the non-residential sub-sector was influenced by renewed interest in commercial and mixed development in line with business activities, while the residential sub-sector was supported by demand in prime locations. Going forward, the construction sector is expected to benefit from the acceleration of projects under the Ninth Malaysia Plan.

Construction Indicators

	2005		2006		
	3Q	4Q	1Q	2Q	3Q
	Annual change (%)				
New sales and advertising permits	45.4	11.4	-23.6	-20.3	-21.7
Housing approvals	2.8	2.8	-43.4	-7.4	-12.6
Production of construction-related materials	-3.5	-3.8	-6.6	-0.6	8.0
Loans approved for construction	-7.3	3.4	-33.0	5.5	8.2
Imports of construction materials and mineral products	-23.7	0.2	2.6	-0.8	37.3[1]

[1] July-August 2006
Source: Ministry of Housing and Local Government and Department of Statistics, Malaysia.

GDP by Expenditure Components (at constant 1987 prices)

	2005		2006		
	3Q	4Q	1Q	2Q	3Q
	Annual change (%)				
Aggregate Domestic Demand (excluding stocks)	9.2	7.2	8.1	7.4	6.0
Consumption	9.0	9.9	6.8	7.3	7.1
Private sector	10.4	9.0	7.5	7.3	6.8
Public sector	4.7	12.6	3.8	7.2	8.3
Gross Fixed Capital Formation	9.6	0.4	11.4	7.6	3.5
Exports of Goods and Services	5.8	9.7	5.9	4.9	10.5
Imports of Goods and Services	8.2	8.0	10.8	7.7	7.4
GDP	**5.3**	**5.2**	**5.9**	**6.2**	**5.8**

Source: Department of Statistics, Malaysia

Domestic demand

The private sector continued as the main contributor to domestic demand activities in the third quarter. The public sector remained supportive of growth, with public sector spending showing clear signs of improvement during the third quarter.

The growth in consumption expenditure was sustained at 7.1%. **Private consumption** expenditure in the third quarter, increased by 6.8%. Consumer spending was supported by stable labour market conditions, stronger export earnings and firm commodity prices. In the labour market vacancies remained high amid lower retrenchments. The stronger performance of the stock market during the quarter has also created a positive wealth effect on consumers. Furthermore, various promotions held during the annual nationwide Mega Sales Carnival from end July to early September have encouraged household spending.

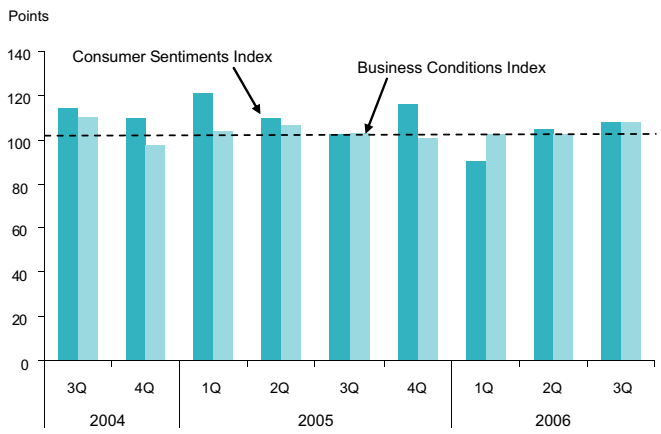
Latest data show that households have taken a more optimistic view going forward. The Consumer Sentiment Index rose further in the third quarter to 107.5 points (2Q: 104.2 points), mainly reflecting households' anticipation of stable incomes and better employment opportunities. Major consumption indicators such as imports of consumption goods and consumer spending on credit cards continued to register sustained growth, reflecting sustained consumer spending. In addition, the OPR had been left unchanged during the quarter, further mitigating the concerns of higher financing costs.

Meanwhile, **public consumption** registered a stronger growth of 8.3% during the quarter, mainly due to higher expenditure on emoluments, supplies and services and defence.

Private investment activities and increased public development spending supported the growth of 3.5% in **gross fixed capital formation.** Private sector capital spending activities were supported by the more favourable business sentiments and

higher capacity utilisation in the manufacturing sector. Improved business sentiment was reflected in the Business Conditions Index for the third quarter, which increased by 5.4 points from the previous quarter (107.8 points, 2Q: 102.4 points) as a result of stronger production activities, rising sales, higher export orders and higher outlays on new plant and equipment. At the same time, Federal Government development expenditure increased with the bulk of the expenditure during the quarter being channelled into agriculture and rural development; education and public utilities.

Improved Business and Consumer Confidence

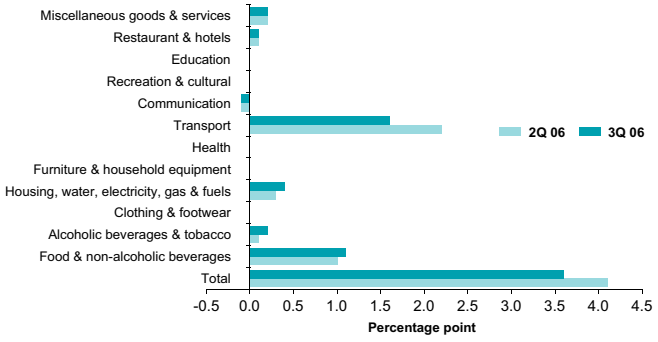


Inflation moderated in the third quarter

For the third quarter of 2006, headline inflation, as measured by the Consumer Price Index, moderated to 3.6% (2Q: 4.1%). As expected, the moderation was due mainly to the lower inflation for items in the transport category (3Q: 10%, 2Q: 13.9%) following the lapse of the August 2005 upward revision in the prices of retail petrol and diesel. The inflation rate for alcoholic beverages and tobacco was higher following the increase in excise duties on these items as announced in the 2007 Budget in September 2006. Meanwhile, the prices of clothing and footwear and communication charges continued to decline compared to levels recorded a year ago. For the first nine months of the year, the headline inflation rate averaged at 3.8% (2.9% during the corresponding period in 2005). This trend has continued in the fourth quarter with inflation moderating further to 3.1% in October.

The DOSM announced a rebasing of the Producer Price Index (PPI) to the year 2000 (previously 1989=100). This exercise also involved the revision of the weights of items in the PPI basket. Based on the new weights, the rate of increase of the PPI moderated to 6.4% in the third quarter (2Q: 7.7%) due to the slower increase in the commodity-related category. In particular, the prices of crude oil and rubber moderated during the quarter to bring down the producer price inflation.

Contribution to Consumer Price Inflation

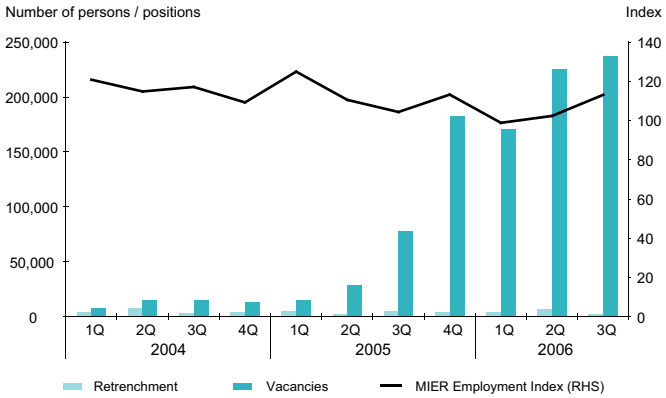


Effective from January 2006, the base reference period for the CPI series is year 2005=100

Stable labour market conditions

The latest data showed that the labour market continued to be stable as job vacancies remained high while retrenchments declined significantly. These positive developments were also reflected in the Employment Index, which climbed by 10.8 points to 113.2 points in the third quarter.

Labour Market Conditions



Total job vacancies reported via the Electronic Labour Exchange surged to 237,407 positions, (2Q: 225,863 positions); with the greatest number of openings reported in the manufacturing (41% share), agriculture (24%), services (17%) and construction (15%) sectors. However, most of the vacancies reported via the Exchange continued to be for lower level job categories, such as elementary occupations (61%), as employers still prefer to go through private employment agencies and/ or advertise in the print media to fill vacancies requiring higher expertise, talent and skills. Total retrenchments during the quarter were sharply lower, with only 2,497 persons being retrenched (2Q: 6,602 persons), in line with the sustained strong demand for labour. The retrenchments mainly affected plant and machine operators and assemblers, general workers, and craft and related trade workers (40% share). About 60% of the layoffs occurred in the manufacturing sector, with one-third of this group comprising of workers from the electronics and electrical industry.

After two quarters of negative growth, real labour productivity in the manufacturing sector recovered in the third quarter (0.7%; 2Q: -2.2%). Growth in real sales value of product per employee was also significantly higher than that of real wages, which continued to decline further (-2.3%; 2Q: -2.1%), indicating limited wage pressures in the manufacturing sector during the period.

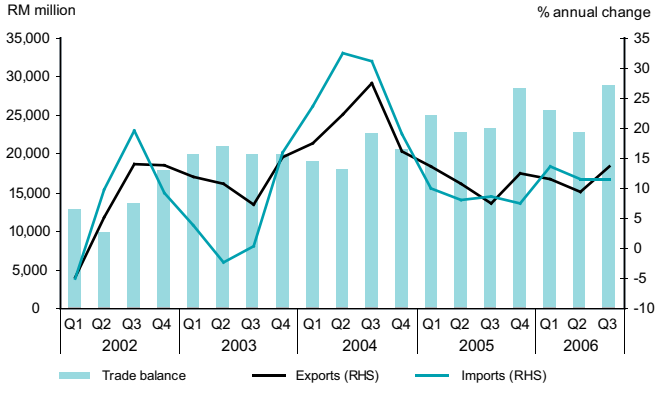
Stronger export growth

In line with strong expansion in manufactured and agriculture exports, the trade account registered a **surplus** of RM28.9 billion in the third quarter of 2006 (2Q: RM22.9 billion). Gross exports expanded by 13.6% (2Q: 9.5%) while import growth was sustained at 11.5% (2Q: 11.5%).

In the third quarter of 2006, gross exports strengthened significantly by 13.6% (2Q: 9.5%) due to higher exports of manufactured goods and agriculture. Meanwhile, exports of minerals grew at a more moderate pace.

Exports of manufactured goods increased by 14.2% (2Q: 10%) mainly supported by exports of E&E and resource-based products. Higher shipment

Trade Balance



of electrical products, in particular telecommunication equipment continued to drive the better export performance of E&E products (10.3%; 2Q: 5.6%). Exports of semiconductors also contributed to the stronger export growth, which is in line with the performance of the global semiconductor industry where unit shipments of microprocessors have increased due to introduction of new products.

Meanwhile, exports of resource-based products continued to grow strongly, led by double-digit growth in exports of chemical, petroleum, rubber and wood products. Export of chemical products improved further to increase by 22.4% (2Q: 9.9%), supported by demand from PR China as well as regional countries, while exports of rubber products (46.3%; 2Q: 38.4%) remained robust due largely to favourable prices. Shipment of wood products increased further by 34.3% (2Q: 10%), mainly supported by demand from Japan.

Agriculture exports registered a strong increase of 20.4% during the quarter (2Q: 3.3%) led mainly by the robust performance of palm oil and rubber exports. Exports of palm oil turned around markedly to rise by 24.5% (2Q: -4%) due to both higher volume (11.4%) and prices (11.7%). The strong increase in demand for Malaysian palm oil was stimulated by increased offtake for use as edible oil, particularly by the Western countries due to the increasing trend to use palm oil to substitute oil containing transfatty acid, and also as feedstock to produce biodiesel. The acceleration in demand was seen particularly from PR China, the European Union (EU), India, Pakistan, and the US. Underpinned by the upturn in demand, palm oil prices rose to an average RM1,604 per tonne (2Q: RM1,461 per tonne). Rubber exports continued to strengthen significantly for the third consecutive quarter, rising by 53%, due entirely to higher prices (+59.5% to 834 sen per kilogramme; 2Q: 727 sen per kilogramme), as volume contracted by 4.1% during the quarter.

Export proceeds from **minerals** increased at a slower rate of 1.3% (2Q: 10.1%) due to a decline in exports of crude oil (-4.1%; 2Q: 19.2%), on account of lower export volume (-15.8%) in line with production trends. Nevertheless, export prices remained high, averaging USD 72.18 per barrel during the quarter as the Malaysian oil, which is of the premium grade, was being traded above other benchmark crude oils in the global oil markets. Exports of liquefied natural gas (LNG) increased at an encouraging pace of 15% due mainly to higher prices (+13% to RM1,114 per tonne) in line with the upward trend in global natural gas prices, as export volume rose only slightly by 1.8%.

Malaysia's export performance continued to be driven by regional markets. Regional exports (excluding Japan) expanded by 16.8% to account for a share of 44.3%. The export performance was underpinned by demand for E&E and resource-based products as well as primary commodities, notably palm oil and crude rubber, by PR China, Singapore, Thailand and Korea. In addition, exports to India increased by 29.2%, spurred mainly by exports of E&E products, crude and refined petroleum products as well as palm oil.

Trade Account

	2005		2006		
	3Q	4Q	1Q	2Q	3Q
	Annual change (%)				
Gross Exports	**7.5**	**12.6**	**11.5**	**9.5**	**13.6**
Manufacturing	*6.3*	*13.1*	*10.6*	*10.0*	*14.2*
Agriculture	*-0.1*	*3.2*	*4.5*	*3.3*	*20.4*
Minerals	*25.8*	*20.2*	*23.0*	*10.1*	*1.3*
Gross Imports	**8.6**	**7.5**	**13.7**	**11.5**	**11.5**
Capital goods	*21.0*	*0.3*	*27.8*	*7.9*	*-6.4*
Intermediate goods	*6.3*	*6.3*	*8.2*	*7.8*	*12.4*
Consumption goods	*5.2*	*4.2*	*14.0*	*12.8*	*15.3*
Trade balance (RM bil)	**23.3**	**28.6**	**25.8**	**22.9**	**28.9**

Source: Department of Statistics, Malaysia

Exports to major trading partners namely the US and the EU (particularly Germany, Netherlands and the UK) increased by 4.2% and 29.9% respectively to account for 32.1% of total exports. Growth was contributed

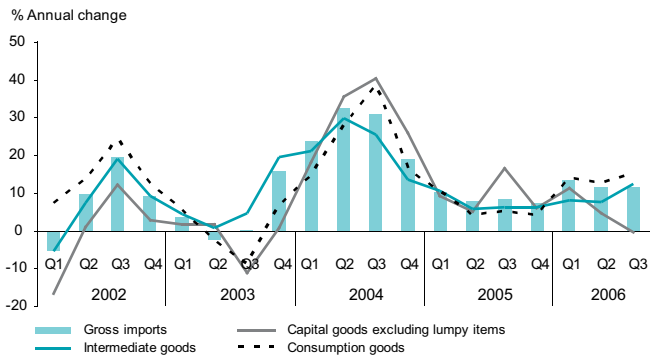
Malaysia: Direction of Exports

	2005		2006			2005		2006			2005		2006		
	3Q	4Q	1Q	2Q	3Q	3Q	4Q	1Q	2Q	3Q	3Q	4Q	1Q	2Q	3Q
	RM billion					Share of total exports (%)					Annual change (%)				
United States	28.9	27.5	24.5	28.1	30.1	21.0	19.3	17.9	19.6	19.2	15.8	18.8	13.4	4.3	4.2
European Union (EU)	15.5	17.5	16.1	17.6	20.1	11.2	12.3	11.8	12.3	12.9	-4.0	11.2	10.0	17.5	29.9
Selected ASEAN countries[1]	34.8	36.7	37.4	37.8	39.9	25.3	25.7	27.3	26.4	25.5	9.3	14.5	14.7	12.0	14.4
North East Asia	24.6	27.0	25.2	26.2	29.5	17.8	18.9	18.4	18.3	18.9	2.2	11.0	7.3	8.8	20.0
People's Republic of China	*8.5*	*10.5*	*8.3*	*9.9*	*12.7*	*6.2*	*7.3*	*6.1*	*6.9*	*8.1*	*-0.8*	*26.2*	*4.4*	*20.3*	*48.9*
Hong Kong China	*8.4*	*7.8*	*7.5*	*7.3*	*7.5*	*6.1*	*5.5*	*5.5*	*5.1*	*4.8*	*13.8*	*6.5*	*6.2*	*-7.7*	*-10.8*
Chinese Taipei	*3.9*	*4.0*	*3.3*	*4.1*	*4.6*	*2.9*	*2.8*	*2.4*	*2.8*	*2.9*	*-6.7*	*-2.4*	*7.2*	*7.3*	*15.8*
Korea	*3.7*	*4.7*	*6.1*	*4.9*	*4.8*	*2.7*	*3.3*	*4.5*	*3.4*	*3.1*	*-3.7*	*2.5*	*12.9*	*18.9*	*28.0*
India	3.9	4.2	4.0	4.1	5.0	2.8	2.9	2.9	2.9	3.2	36.5	32.2	8.3	26.1	29.2
Total exports	137.9	142.6	136.7	143.2	156.6	100.0	100.0	100.0	100.0	100.0	7.5	12.6	11.5	9.5	13.6

[1] Singapore, Thailand, Indonesia, Philippines, Brunei Darussalam and Vietnam
Source: Department of Statistics, Malaysia

mainly by higher exports of E&E products (automatic data processing machines, semiconductor devices, integrated circuits, telecommunication equipment and parts), iron and steel products, as well as primary commodities, namely crude rubber. Export growth to West Asia also strengthened, expanding by 20.4% (2Q: 19.3%).

Import Growth



Meanwhile, import components continued to be sourced from Singapore, PR China, Thailand and Hong Kong. Imports from the regional economies grew by 12.5%, comprising mainly of E&E products, chemicals and chemical products, manufactures of metal as well as iron and steel products.

Growth of **gross imports** was sustained at 11.5% (2Q: 11.5%) reflecting the increase in imported inputs for manufactured exports and domestic consumer spending. Growth of imports of **intermediate goods**, which were inputs used for manufactured goods, strengthened by 12.4% (2Q: 7.8%), driven mainly by higher imports of E&E components such as electronics and parts of telecommunication equipment. Imports of primary and processed materials used by the food and beverage industry and fuel and lubricants continued to increase.

Imports of **capital goods** amounted to RM15.9 billion. Capital imports by selected industries continued to record growth. Capacity expansion and upgrading for fuel efficiency in the manufacturing sector was accelerated. This was most evident in the petrochemicals industry, for which growth in imports reflected the increased imports for machinery, generators, turbines and electric motors. Increased exploration activities in the oil and gas industry led to higher imports of construction and mining equipment.

Consistent with sustained private consumer spending and higher demand in anticipation of festivities, imports of **consumption goods** increased by 15.3% (2Q: 12.8%). The growth reflected mainly

Malaysia: Imports by End Use And Broad Economic Categories (BEC) Classification

	2005		2006		
	3Q	4Q	1Q	2Q	3Q
	Annual change (%)				
CAPITAL GOODS	**21.0**	**0.3**	**27.8**	**7.9**	**-6.4**
Capital goods (except transport equipment)	18.6	5.3	16.1	2.3	1.4
Transport equipment	39.4	-26.8	173.3	50.5	-57.1
INTERMEDIATE GOODS	**6.3**	**6.3**	**8.2**	**7.8**	**12.4**
Food and beverages, mainly for industry	-6.7	6.9	29.0	28.0	24.8
Industrial supplies, n.e.s.	1.8	0.6	1.2	0.9	22.9
Fuel and lubricants	24.5	32.2	21.1	40.1	45.2
Parts and accessories of capital goods (except transport equipment)	5.3	5.6	9.2	7.2	1.4
Parts and accessories of transport equipment	39.4	11.3	8.8	-8.3	3.6
CONSUMPTION GOODS	**5.2**	**4.2**	**14.0**	**12.8**	**15.3**
Food and beverages, mainly for household consumption	5.8	-1.2	3.4	5.4	4.6
Transport equipment, non-industrial	-0.9	17.5	23.6	16.4	-35.0
Consumer goods, n.e.s.	5.1	7.4	20.9	17.2	23.3
Durables	*6.3*	*12.3*	*31.3*	*-7.5*	*5.5*
Semi-durables	*-3.0*	*5.1*	*27.4*	*41.6*	*46.8*
Non-durables	*10.9*	*6.5*	*11.6*	*13.8*	*15.4*
DUAL USE GOODS	**18.9**	**12.2**	**23.2**	**1.0**	**14.8**
OTHERS	**2.5**	**4.9**	**12.0**	**8.6**	**-25.1**
RETAINED IMPORTS	**8.5**	**5.4**	**11.6**	**7.9**	**9.1**
RE-EXPORTS	**10.2**	**53.4**	**52.7**	**92.8**	**62.0**
GROSS IMPORTS	**8.6**	**7.5**	**13.7**	**11.5**	**11.5**

Source: Department of Statistics, Malaysia

increases in semi-durable consumer goods, notably clothing and footwear and non-durables such as medicine, soap and cosmetics. Exploration activities in the oil and gas industry has contributed to strong growth in imports for re-exports (31.9%; 2Q: 46.7%) as iron and steel pipes were imported, coated for corrosion and re-exported.

Larger inflows of FDI

On a cash basis, gross inflows of **foreign direct investment (FDI)** increased to RM10 billion (2Q: RM9.1 billion), attributed mainly to larger inflows of equity capital and inflows of inter-company loans. FDI in the form of equity capital was broad based, channelled mainly into the manufacturing, oil and gas and services sectors. In the manufacturing sector, FDI inflows were mainly concentrated in the electrical and electronics, petroleum-related products as well as chemical-related industries. In the services sector, FDI inflows were directed primarily into the finance, insurance, real estate and business services as well as restaurants, hotels, wholesale and retail trade sub-sectors. Meanwhile, the bulk of the inter-company loans was in the form of short-term loans extended by foreign companies to their subsidiaries in Malaysia, particularly in the finance, insurance, real estate and business services and oil and gas sectors. The bulk of these loans was repaid during the same quarter. After adjustments for gross outflows due mainly to these repayments, net FDI had more than doubled, amounting to RM5.4 billion (2Q: RM2.5 billion). The FDI data on cash basis does not include reinvested retained earnings and investment in the form of imported machinery and equipment.

Overseas investment by Malaysian companies recorded a lower gross outflow of RM25 billion (2Q: -RM33.3 billion) reflecting mainly smaller extension of short-term inter-company loans by non-resident controlled companies in the oil and gas sector to their related companies abroad arising from their centralised treasury operations. These outflows were largely offset by inflows from the repayment of these short-term loans during the quarter. As a result, overseas investment recorded a lower net outflow of RM2 billion (2Q:-RM3.6 billion). The bulk of the net outflows for overseas investment was in the form of equity capital, channelled mainly into the services, manufacturing and oil and gas sectors. In the services sector, overseas investment was led by companies in the finance, insurance and business services as well as transport, storage and communication sub-sectors. Meanwhile, in the manufacturing sector, overseas investment was effected largely by companies in the automotive, chemical-related and wood-related industries.

Portfolio investment registered a net outflow of RM3.1 billion (2Q: +RM0.9 billion) reflecting outflows in both equity and debt securities. During the quarter, gross inflows and outflows for portfolio investment were sustained at high levels as in the preceding quarter.

External debt declined

Malaysia's total external debt declined to RM197.7 billion or USD53.1 billion as at end-September 2006 (2Q: RM198.1 billion or USD53.4 billion), equivalent to 37.6% of Gross National Product (GNP). The **medium- and long-term external debt** declined to RM148.3 billion (2Q: RM149.7 billion) on account of a higher net repayment by the public sector. In particular, the Non-Financial Public Enterprises (NFPEs) registered a higher net repayment of RM2.4 billion (2Q: -RM0.9 billion), reflecting both scheduled repayments and prepayments of some loans, particularly by companies in the oil and gas sector to reduce their debt exposure. The Federal Government also recorded a net repayment of external loans (-RM0.2 billion; 2Q: +RM0.1 billion). Meanwhile, the private sector registered a net borrowing of RM1 billion, effected mainly by companies in the manufacturing, and oil and gas sectors.

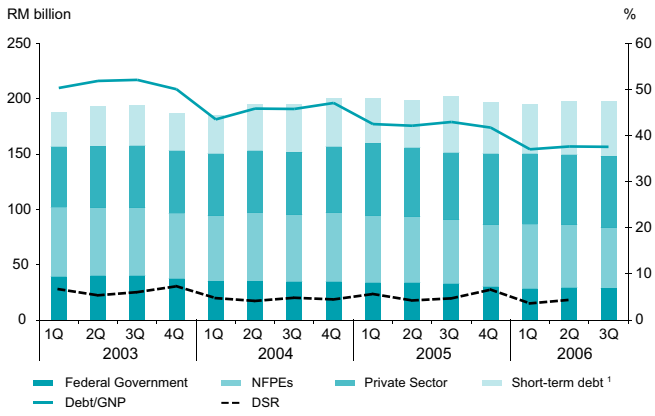
External Debt Outstanding

	2005	2006	
	3Q	2Q	3Q [P]
	RM billion		
Medium- and Long-term debt	152.0	149.7	148.3
Public sector	90.6	86.2	83.7
Private sector	61.4	63.5	64.6
Short-term debt[1]	50.7	48.4	49.4
Total external debt	202.7	198.1	197.7
- USD billion equivalent	53.3	53.4	53.1

[1] Excludes currency and deposits held by non-residents with resident banking institutions
[P] Preliminary

Source: Ministry of Finance, Malaysia and Bank Negara Malaysia

External Debt Outstanding



[1] Excludes currency and deposits held by non-residents with resident banking institutions

The total **short-term external debt** increased to RM49.4 billion or USD13.3 billion (2Q: RM48.4 billion), attributed largely to higher borrowings by the non-bank private sector arising mainly from inter-company loans. As at end-September 2006, the short-term external debt accounted for 25% of total external debt and was 16.9% of the net international reserves.

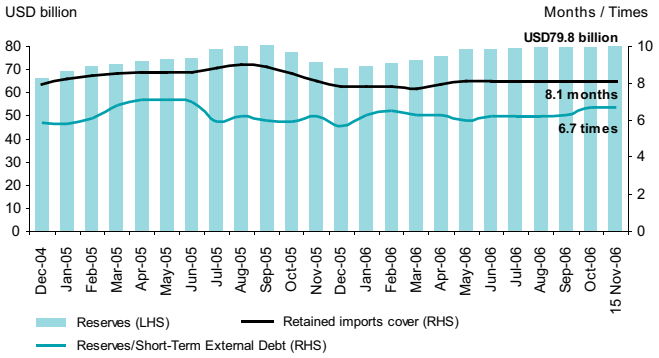
International reserves

The international reserves of Bank Negara Malaysia amounted to RM293.1 billion or equivalent to USD79.5 billion as at 29 September 2006. The reserves level also reflected the quarterly adjustment of the foreign exchange revaluation gains, following the appreciation of major currencies against the ringgit. The reserves amounted to RM294.1 billion or equivalent to USD79.8 billion as at 15 November 2006. The reserves position is sufficient to finance 8.1 months of retained imports and is 6.7 times the short-term external debt.

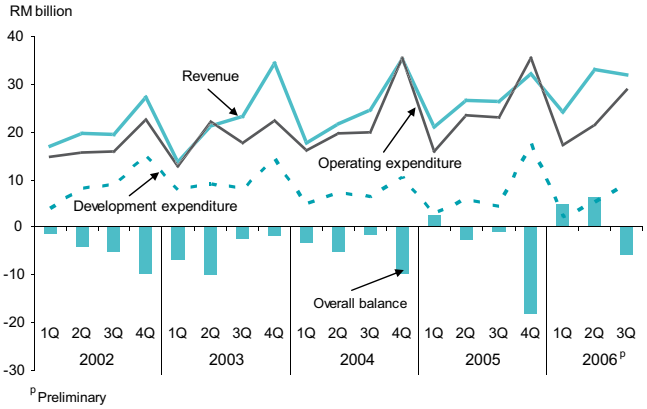
Higher Federal Government spending

Expansionary budgetary operations of the Federal Government was supportive of domestic economic activity in the third quarter. Higher development expenditure was channelled to the economic and social services sectors. Total expenditure rose by 38.4%, resulting in the financial position of the Federal Government recording a fiscal deficit of RM5.8 billion or 4.1% of GDP. The deficit was financed from domestic borrowings and the drawdown of realisable assets. Total Federal Government debt rose by 8% to RM245.8 billion at end-September 2006, equivalent to 44.8% of estimated GDP for 2006.

Net International Reserves (as at end period)



Federal Government Finance



Federal Government Finance[P]

	2005		2006		
	3Q	Jan-Sep	2Q	3Q	Jan-Sep
	RM billion				
Revenue	26.4	74.1	33.0	31.9	89.1
% growth	*7.3*	*15.6*	*24.2*	*20.8*	*20.2*
Operating expenditure	23.0	62.3	21.6	28.8	67.7
% growth	*15.3*	*11.7*	*-7.7*	*25.2*	*8.7*
Current account	**3.4**	**11.8**	**11.4**	**3.1**	**21.4**
% of GDP	***2.6***	***3.2***	***8.5***	***2.2***	***5.3***
Gross development expenditure	4.4	13.1	5.2	9.1	16.4
% growth	*-30.2*	*-28.8*	*-12.2*	*108.1*	*25.6*
Overall balance	**-0.8**	**-0.9**	**6.4**	**-5.8**	**5.5**
% of GDP	***-0.6***	***-0.2***	***4.8***	***-4.1***	***1.4***
Memo item:					
Total gross expenditure	27.3	75.4	26.8	37.8	84.1
% growth	*4.5*	*1.6*	*-8.6*	*38.4*	*11.6*
Total Federal Government debt (as at end-period)	227.6	227.6	240.2	245.8	245.8
% of GDP	*46.0*	*46.0*	*43.8*	*44.8*	*44.8*
Domestic debt	194.5	194.5	211.1	216.9	216.9
% of GDP	*39.3*	*39.3*	*38.5*	*39.6*	*39.6*
External debt	33.2	33.2	29.1	28.9	28.9
% of GDP	*6.7*	*6.7*	*5.3*	*5.3*	*5.3*

[P] Preliminary

MONETARY AND FINANCIAL DEVELOPMENTS

Interbank rates remained relatively stable, while real FD rates on longer tenures turned positive

With inflation moderating and as available data point towards a sustained steady expansion in the domestic economy, the Overnight Policy Rate (OPR) was left unchanged at 3.50% throughout the third quarter.

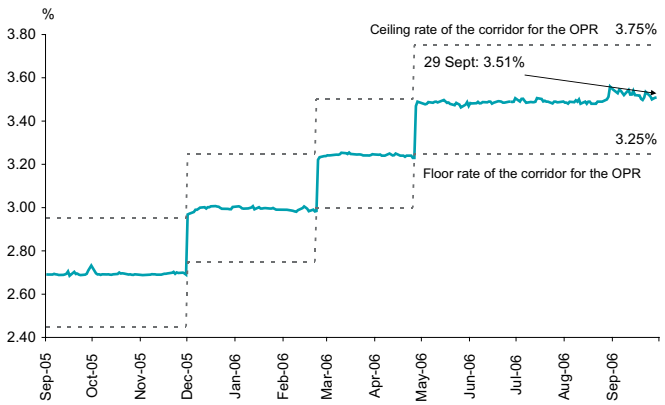
During the period 3 July - 29 September, the average overnight interbank rate remained relatively stable, moving within a range of 3.48% - 3.56%. Some temporary volatility occurred in early September when several money market participants sourced funds in preparation for the MGS auction. On the whole, the average overnight interbank rate was close to the OPR. Money market participants pared down their interest rate expectations and this resulted in the marginal downward adjustment of the 1-month interbank rate in August to 3.69%, where it stabilised thereafter.

In the retail market, the average base lending rate of CBs remained unchanged at 6.72%. The average lending rate of CBs was lower than the average BLR, peaking at 6.63% in July, and remaining relatively stable at that level for the remainder of the third quarter (2Q: 6.55%). Meanwhile, the average quoted FD rates of CBs for the 1-month and 12-month maturities ranged between 3.13% and 3.77% respectively (2Q: 3.11% and 3.77%). Of significance, the real average FD rates of CBs for the 6-month, 9-month and 12-month maturities turned positive in August as inflation trended lower.

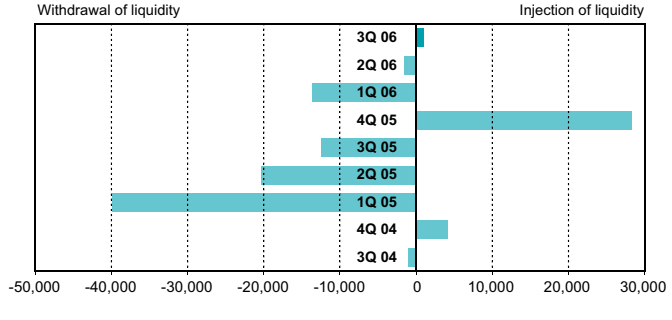
Interest Rates

	2005		2006		
	3Q	4Q	1Q	2Q	3Q
	At end-period (%)				
Overnight Policy Rate (OPR)	2.70	3.00	3.25	3.50	3.50
Interbank rates					
Overnight	2.73	3.00	3.25	3.51	3.51
1-month	2.87	3.12	3.25	3.78	3.68
Base lending rates (BLR)					
Commercial banks	5.98	6.20	6.47	6.72	6.72
Average lending rates (ALR)					
Commercial banks	5.90	6.12	6.29	6.55	6.63
Fixed deposit rates					
Commercial banks					
3-month	3.00	3.02	3.06	3.18	3.21
12-month	3.70	3.70	3.70	3.77	3.77

Daily weighted Average Overnight Interbank Rate



BNM Liquidity Operations (During the quarter, RM million)

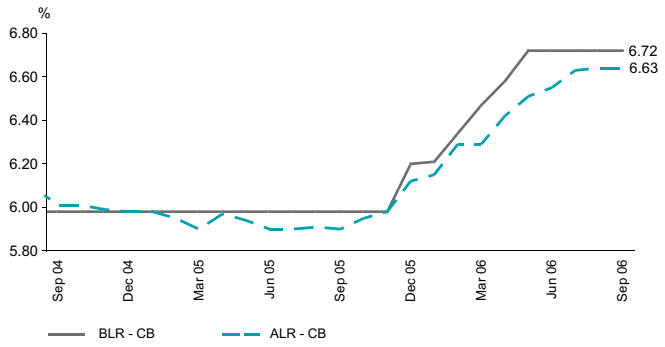


Monetary aggregates expanded at higher growth rates

All monetary aggregates continued to register higher annual growth rates in the third quarter. M1, or narrow money, expanded at an annual rate of 11.5% (2Q: 10.1%), reflecting higher placements of demand deposits and currency held by the private sector. Meanwhile, M3, or broad money increased at an annual rate of 7.9% (2Q: 6.4%).

In terms of determinants, both claims on the private sector and net external operations were expansionary on M3. Claims on the private sector continued to expand, albeit at a more moderate pace, with marginally slower growth in loans outstanding and lower holdings of private debt securities by the banking system. Net external operations had a larger expansionary impact during the quarter, supported mainly by the increases in the net external assets of the banking system. Net claims on the Government, meanwhile, were contractionary on M3 as the Government deposited the proceeds from the issuance of MGS and Government Investment Issues (GII) with Bank Negara Malaysia and the banking system.

Lending Rates of Commercial Banks
(Average for the period)

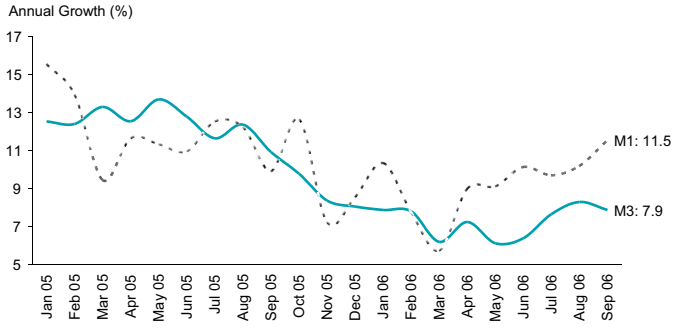


Determinants of Broad Money, M3

	Change during the period				
	2005		2006		
	3Q	4Q	1Q	2Q	3Q
	RM billion				
M3	4.3	10.8	16.5	10.0	14.3
Net claims on Government	-4.3	12.6	2.8	-11.2	-2.2
Claims on private sector	15.0	14.2	4.9	15.0	6.7
Loans	*15.7*	*8.6*	*6.9*	*12.2*	*9.2*
Securities	*-0.7*	*5.6*	*-2.0*	*2.7*	*-2.5*
Net external operations[1]	-1.1	-23.7	14.0	11.3	11.9
BNM	*20.5*	*-34.7*	*10.8*	*14.2*	*2.0*
Banking system	*-21.6*	*11.0*	*3.2*	*-2.9*	*9.9*
Other influences	-5.3	7.6	-5.2	-5.1	-2.1

[1] Pre-revaluation

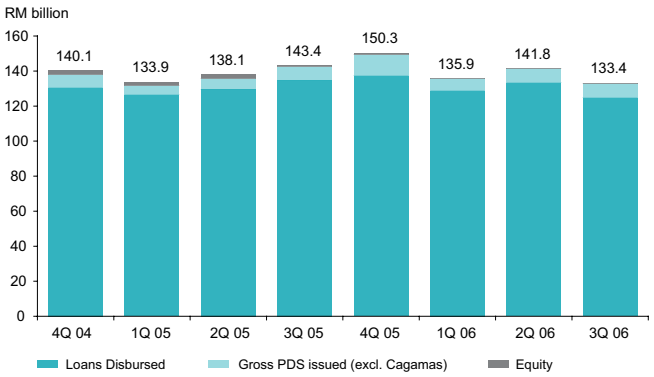
Monetary Aggregates



Slower private sector financing growth in the third quarter

In the third quarter, gross financing of the private sector through the banking system and capital market amounted to RM133.4 billion, lower by 6.9% on an annual basis (2Q: RM141.8 billion or +2.6%). The lower level of gross financing reflected the slower pace of loan disbursements by the banking system. Funds raised through the capital market were relatively stable on a quarterly basis. On a net basis, banking system loans and PDS outstanding expanded at a combined annual rate of 7.9% at end-September (end-June: 9.1%).

Gross Private Sector Financing through Banking System and Capital Market



Financing of the Private Sector through Banking System and Capital Market

	During the period (RM billion)				Annual growth (%)		
	2005	3Q 05	2Q 06	3Q 06[P]	2005	2Q 06	3Q 06[P]
Gross total financing	**565.6**	**143.4**	**141.8**	**133.4**	**8.7**	**2.6**	**-6.9**
Loans disbursed *	528.6	134.8	133.6	125.0	8.3	3.0	-7.3
Gross PDS (excl. Cagamas)	30.8	7.7	7.8	7.9	20.3	28.5	3.4
Equity	6.3	0.9	0.4	0.5	-2.5	-84.1	-39.2
Outstanding total financing (A)+(B)	**62.2**	**18.6**	**16.3**	**11.6**	**9.3**	**9.1**	**7.9**
Banking system	46.3	14.5	16.9	10.4	8.5	9.7	8.8
Loans outstanding (A)	44.2	14.4	13.0	9.6	8.6	8.6	7.5
Holding of PDS	2.1	0.0	3.9	0.8	6.3	28.5	30.8
PDS outstanding (B)	18.0	4.2	3.3	2.0	11.4	10.8	9.2
Memorandum item							
Gross PDS (incl. Cagamas)	10.6	9.7	10.8	9.2	-70.9	37.8	-5.1

[P] Preliminary
* Banking system loans include loans sold to Cagamas

Loan Indicators

	During the period (RM billion)				Annual Growth %			
	2005	3Q 05	2Q 06[P]	3Q 06[P]	2005	3Q 05	2Q 06[P]	3Q 06[P]
Total								
Loan applications[n]	305.4	83.9	74.7	79.3	11.7	9.7	-7.6	-5.5
Loan approvals[n]	192.2	54.4	48.6	46.7	10.7	16.6	2.2	-14.0
Loan disbursements[n]	528.6	134.8	133.6	125.0	8.3	10.0	3.0	-7.3
Loan repayments[n]	488.5	121.5	122.9	115.3	5.8	2.8	2.0	-5.1
Change in loan outstanding*	44.2	14.4	13.0	9.6	8.6	9.2	8.6	7.5
Of which:								
Business enterprises**								
Loan applications[n]	153.1	42.2	40.5	41.1	6.8	0.1	-0.6	-2.4
Loan approvals[n]	88.3	26.1	23.8	22.6	9.4	21.3	17.1	-13.3
Loan disbursements[n]	375.1	94.8	92.2	88.3	7.0	9.3	0.3	-6.8
Loan repayments[n]	367.1	90.9	87.4	84.2	5.3	1.0	-3.9	-7.4
Change in loan outstanding*	6.5	4.9	6.0	3.0	3.0	3.9	4.2	3.3
SMEs***								
Loan applications[n]	59.7	17.3	18.0	18.8	10.3	13.9	n.a.	n.a.
Loan approvals[n]	34.5	9.9	9.7	10.2	9.3	12.6	n.a.	n.a.
Loan disbursements[n]	110.6	28.4	36.4	33.6	10.2	14.7	n.a.	n.a.
Change in loan outstanding*	7.7	3.0	0.3	1.0	8.7	9.8	n.a.	n.a.
Large corporations***								
Loan applications[n]	93.4	24.8	22.5	22.4	4.8	-7.6	n.a.	n.a.
Loan approvals[n]	53.8	16.2	14.0	12.4	9.5	27.2	n.a.	n.a.
Loan disbursements[n]	264.5	66.4	55.7	54.7	5.7	7.2	n.a.	n.a.
Change in loan outstanding*	-0.1	1.8	5.7	2.0	-0.9	0.0	n.a.	n.a.
Households								
Loan applications[n]	152.3	41.8	34.2	38.2	17.2	21.5	-14.7	-8.6
Loan approvals[n]	103.9	28.3	24.8	24.1	12.0	12.8	-9.0	-14.7
Loan disbursements[n]	153.5	40.0	41.4	36.6	11.7	11.5	9.5	-8.4
Loan repayments[n]	121.4	30.6	35.5	31.1	7.6	8.5	19.7	1.5
Change in loan outstanding*	40.0	11.3	7.1	7.4	15.1	14.9	13.3	11.4

* The annual growth is for end-period.

** Following reclassifications under the Financial Institutions Statistical System (FISS) effective April 2006, in order to maintain comparability on an annual basis for loan applications, approvals, disbursements and repayments, the category business enterprises has been expanded to include loans to other customers, namely non-bank financial institutions, Government, domestic non-business entities and foreign entities. These loans account for a relatively small share of the total compared with business enterprises. Trend wise, growth rates remain similiar to those under the previous definition.

*** From 1Q 2006, loan indicators for SMEs and large corporations are not comparable on an annual basis as beginning March 2006, financial institutions have begun adopting the Standard SME Definitions as approved by the National SME Development Council, resulting in some reclassification between SMEs and large corporations.

n.a. Not applicable.
[n] Numbers may not add up due to rounding.

[P] Preliminary. Data is subject to revision, arising from changes in the classification of loan indicators by economic sectors and purpose.

Source: Bank Negara Malaysia.

Among the major loan indicators, total loan applications from the household sector increased compared with the preceding quarter, mainly on account of higher applications for the purchase of passenger cars and residential property. Loan approvals to the household sector remained relatively steady compared with the previous quarter, with higher approvals for the purchase of passenger cars and credit card loans. Meanwhile, in the business sector, loan approvals and applications by small-and-medium enterprises (SMEs) were higher, amounting to RM18.8 billion and RM10.2 billion respectively.

In terms of the distribution of loan disbursements, almost 44% went to large corporations, followed by households and SMEs. In terms of sectors of the economy, the manufacturing sector received almost a quarter of all loans disbursed during the quarter, followed by the wholesale, retail, restaurants and hotels sector. Consumption credit accounted for almost one-fifth of loans disbursed during the quarter.

Loans by Sector

	Loans disbursed					Loans out-standing
	During the period				Share of total	Share of total
	2005	3Q 05	2Q 06[P]	3Q 06[P***]		
	RM billion				%	
Business enterprises *	375.1	94.8	92.2	88.3	70.7	39.7
Large corporations **	*264.5*	*66.4*	*55.7*	*54.7*	*43.8*	*22.2*
SMEs **	*110.6*	*28.4*	*36.4*	*33.6*	*26.9*	*17.6*
Households	153.5	40.0	41.4	36.6	29.3	55.6
Selected sectors						
Agriculture, hunting, forestry and fishing	13.8	4.0	3.5	3.5	2.8	2.2
Mining and quarrying	1.6	0.4	0.7	0.5	0.4	0.3
Manufacturing	126.7	32.0	29.7	30.3	24.2	11.3
Construction	30.4	8.0	7.8	7.6	6.0	5.3
Real estates	9.0	2.4	3.3	2.2	1.8	3.0
Electricity, gas and water supply	7.1	1.6	0.2	0.4	0.3	0.9
Wholesale, retail, restaurants and hotels	97.2	25.6	23.3	21.7	17.4	8.9
Transport, storage and communication	9.8	3.3	2.7	2.3	1.9	1.9
Finance, insurance and business services	35.7	7.4	10.7	10.6	8.5	5.8
Consumption credit	100.8	26.5	25.9	24.3	19.5	23.6
Of which:						
Credit cards	*42.7*	*11.0*	*11.4*	*11.9*	*9.5*	*3.2*
Purchase of passenger cars	*39.2*	*10.7*	*8.8*	*8.4*	*6.8*	*15.8*
Total	**528.6**	**134.8**	**133.6**	**125.0**	**...**	**...**

* Following reclassification under the Financial Institutions Statistical System (FISS) effective April 2006, in order to maintain comparability on an annual basis for loan applications, approvals, disbursements and repayments, the category business enterprises has been expanded to include loans to other customers, namely non-bank financial institutions, Government, domestic non-business entities and foreign entities. These loans account for a relatively small share of the total compared with business enterprises.

** From 1Q 2006, loan indicators for SMEs and large corporations are not comparable on an annual basis as beginning March 2006, financial institutions have begun adopting the Standard SME Definitions as approved by the National SME Development Council, resulting in some reclassification between SMEs and large corporations.

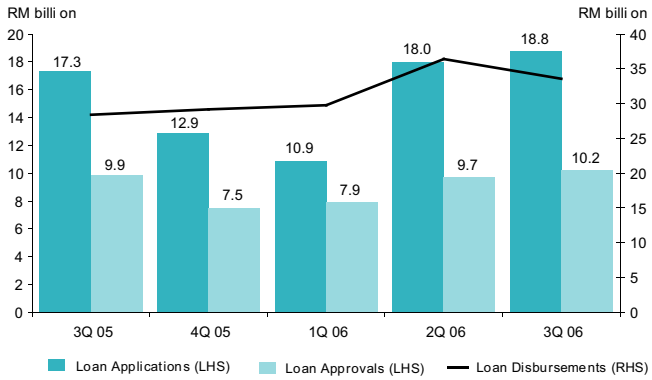
*** Based on new classification system under the Financial Institutions Statistical System (FISS), effective April 2006. Futher details are available in the July issue of the Monthly Statistical Bulletin.

P Preliminary. Data is subject to revision, arising from changes in the classification of loan indicators by economic sectors and purpose.

Source: Bank Negara Malaysia

Total loans outstanding expanded by 7.5% on an annual basis at the end of the third quarter (end-2Q: 8.6%), with loans outstanding to businesses and households increasing at annual rates of 3.3% and 11.4% respectively (end-2Q: 4.2% and 13.3% respectively).

Bank Lending to SMEs



*From March 2006, financial institutions have begun adopting the Standard SME Definitions as approved by the National SME Development Council, resulting in some reclassification between SMEs and large corporations.

Financing activity in the capital market remained significant

Fund raising in the capital market remained active during the quarter with total net funds raised by both the public and private sectors amounting to RM3.8 billion. The **public sector** raised gross funds amounting to RM12.3 billion from four issuances of Government securities: one issuance of 5-year GII, two reopenings of 3-year and 10-year MGS, and a new issuance of 20-year MGS. After adjusting for redemptions, the net funds raised by the public sector during the quarter were lower, amounting to RM3.6 billion (2Q: RM7.4 billion).

In the **private sector**, gross funds raised from the PDS market amounted to RM9.2 billion (RM7.9 billion if excluding Cagamas). The funds were mainly raised through the issuance of medium-term notes and long-term bonds, which accounted for 46% and 42% respectively of total PDS issued. On a net basis, the funds raised through the PDS market, excluding Cagamas bonds, amounted to RM2.4 billion during the quarter (2Q: RM3.3 billion).

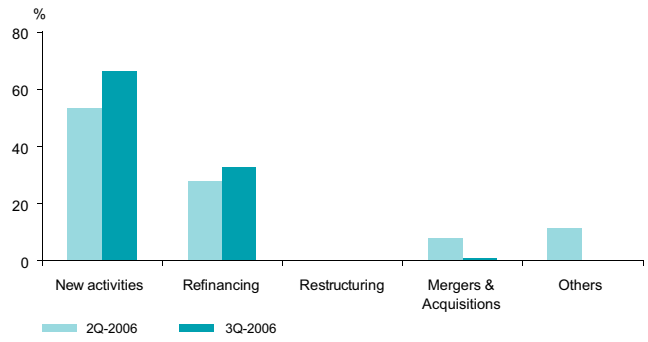
Funds raised through the equity market during the third quarter amounted to RM518 million. Most of the funds were raised through 10 initial public offerings (IPOs) totaling about RM371 million. During the quarter, there were 12 new listings on Bursa Malaysia, two on the Main Board, three on the Second Board and seven on the Malaysian Exchange of Securities Dealing and Automated Quotation (MESDAQ) Market.

Funds Raised in the Capital Market

	2005		2006		
	3Q	4Q	1Q	2Q	3Q
	RM million				
By Public Sector					
Government Securities, *gross*	8,233	6,500	5,265	5,741	9,324
Less Redemptions	2,450	4,850	500	1,300	8,200
Less Government holdings	-	-	-	-	-
Equals Net Federal receipts	5,783	1,650	4,765	4,441	1,124
Khazanah Bonds, *net*	-	-	(1,700)	-	-
Govt. Investment Issues, *net*	-	(1,000)	-	3,500	3,000
Merdeka Savings Bond, *net*	383	397	(500)	(502)	(495)
Net Funds Raised	6,166	1,047	2,564	7,438	3,629
By Private Sector					
Shares	851	1,043	381	384	518
Debt securities	9,726	15,161	10,574	10,784	9,233
Private Debt Securities (PDS)	9,726	13,801	6,889	8,819	7,933
Cagamas	-	1,360	3,685	1,965	1,300
Less Redemptions	5,627	4,701	5,498	7,684	9,590
Net Issues	4,099	10,461	5,076	3,099	(356)
Net issues (excluding Cagamas)	6,359	9,851	2,993	3,314	2,404
Net Funds Raised	4,950	11,504	5,457	3,484	161
Total Net Funds Raised	11,116	12,552	8,022	10,922	3,790
Short-term Papers and Notes, *net* [1]	454	456	1,312	1,175	(577)
Total	11,570	13,008	9,334	12,097	3,213

[1] Refers to Commercial Papers and Cagamas Notes only.

Private Debt Securities Issued by Purpose (% of total)



Higher secondary trading in the bond market

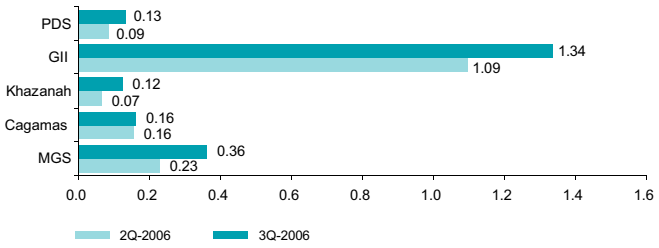
In the secondary market, total trading increased significantly to RM114.9 billion in the third quarter (2Q: RM74.7 billion). Government Securities (MGS and GII) accounted for the bulk of the trading (75% of the total trades), followed by PDS, which accounted for 21% of total trades. In terms of liquidity, the GII was the most liquid paper, registering a liquidity ratio of 1.34.

The MGS benchmark yield curve shifted downwards between 33 – 89 basis points across all tenures during the third quarter of 2006. The downward shift was mainly attributed to the lower than expected inflation in June and August, which resulted in the market expecting that the OPR will remain unchanged. In addition, the market's perception that the appreciation of the ringgit in September may lower imported inflation also contributed to the downward shift in the yield curve. As a result, the quarterly yield spreads of the 3-year, 5-year and 10-year MGS declined by 57, 61 and 89 basis points respectively.

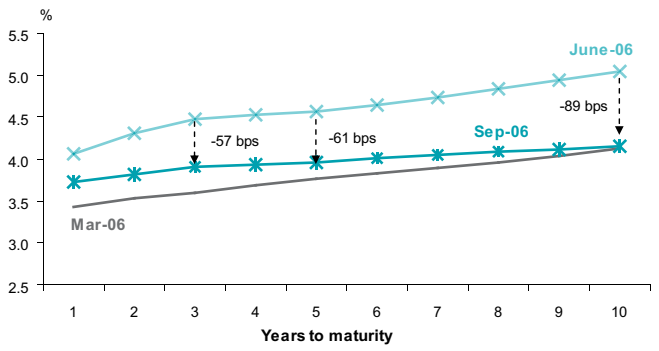
The KLCI improved during the third quarter

Global and regional equity markets strengthened in the third quarter of 2006. In Malaysia, the Kuala Lumpur Composite Index (KLCI) was lifted by positive sentiments arising from the allocations of construction projects in the Ninth Malaysia Plan and a growth-supportive Budget 2007 which included reductions in corporate income tax for 2007 and 2008. In addition, the stronger than expected second quarter GDP growth and benign inflation outlook also contributed to the better performance of the KLCI.

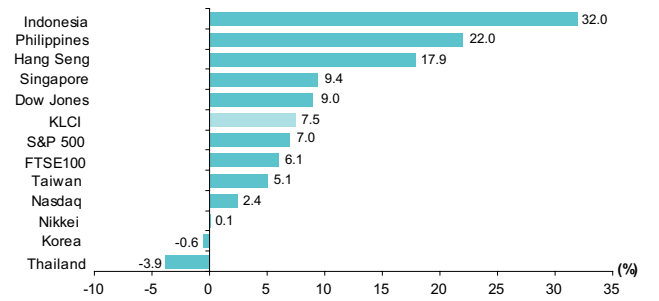
Liquidity Ratio: Turnover / Outstanding



Trend in MGS Yield



Performance of Selected Global and Regional Markets in the Third Quarter of 2006 (30 Dec 2005 - 30 September 2006)



The KLCI rose 52.86 points or 5.8% (2Q: -11.94 points) to end the third quarter at 967.55 (end-2Q: 914.69). Market capitalisation was higher at RM745.5 billion (2Q: RM 721.79 billion), but trading activity declined, with the average daily turnover at 573.9 million units during the quarter (2Q: 931.9 million units).

As at 20 November 2006, the KLCI rose further to 1,033.52 points (since end-2005: +14.9%). Market capitalisation was also higher, at RM805.4 billion (since end- 2005: +15.8%).

Bursa Malaysia: Turnover of Corporate Securities

	2005				2006					
	2Q		1H		1Q		2Q		3Q	
	million units	RM million	million units	RM million	million units	RM million	million units	RM million	million units	RM million
Turnover	25,824	40,423	55,867	96,684	45,988	53,671	57,775	68,662	37,040	49,741
of which:										
Main Board	18,253	35,778	39,489	84,162	26,565	42,744	36,340	54,879	22,422	40,720
of which										
Consumer Products	872	2,072	1,890	5,189	1,808	4,834	1,320	4,245	660	2,200
Industrial Products	2,996	3,076	7,825	8,842	3,147	3,133	5,201	5,432	3,410	3,787
Construction	810	1,287	2,389	4,401	3,048	3,120	3,676	4,799	1,596	2,626
Trading/Services	4,055	14,160	8,375	29,870	6,191	14,985	8,855	19,699	5,958	15,148
Finance	2,173	8,253	5,232	18,748	2,711	9,046	3,218	9,562	2,475	7,291
Properties	3,767	3,069	7,134	8,671	4,106	2,040	7,090	2,928	4,084	2,331
Plantations	453	1,951	1,057	4,119	518	2,708	782	4,118	1,078	4,848
Mining	0	7	0	8	0	1	0	1	1	17
Second Board	4,194	2,960	9,731	8,546	5,837	4,532	6,792	5,304	3,853	2,758

Source: Bursa Malaysia

Exchange Rate Developments

In the third quarter of 2006, movements of the ringgit exchange rate reflected broadly market demand and supply conditions. During the period, the ringgit depreciated against the US dollar amidst range-bound trading. In addition to trade and investment flows, the ringgit was affected by developments in the currencies of the major industrialised economies. The US dollar was supported by safe-haven flows in reaction to geopolitical developments in the Middle East and North Korea, as well as some positive US economic data. The ringgit, however, appreciated against the Japanese yen as the Japanese currency weakened amidst reduced expectations for further interest rates increases.

During the third quarter, the ringgit depreciated against most regional currencies in the range of

Bursa Malaysia: Selected Market Indicators

	As at end				
	2005		2006		
	2Q	1H	1Q	2Q	3Q
Price Indices					
Composite	888.3	888.3	926.6	914.7	967.6
FBM30	-	-	-	5919.4	6260.4
EMAS	203.7	203.7	213.4	-	-
FBMEMAS	-	-	-	5973.7	6270.7
Second Board	87.8	87.8	91.1	93.7	83.2
Average daily turnover					
Volume (million units)	416.5	461.7	779.5	931.9	573.9
Value (RM million)	652.0	797.0	909.7	1107.5	782.0
Market capitalisation (RM b)	688.6	688.6	732.9	721.8	745.5
No. of companies listed	990.0	990.0	1025.0	1026.0	1027.0

Source: Bursa Malaysia

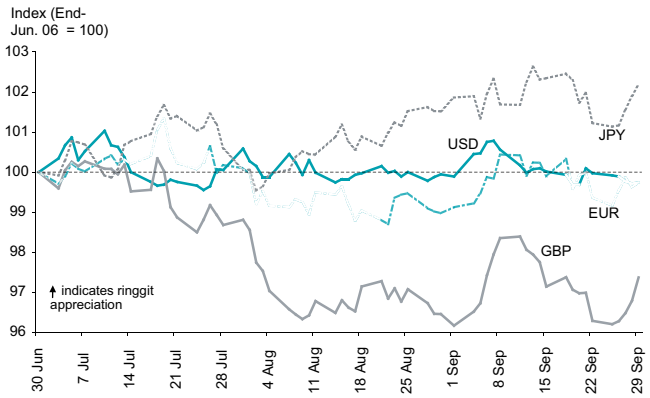
Summary of Ringgit Performance Against Selected Currencies Percent Change (1 July - 30 September 2006)



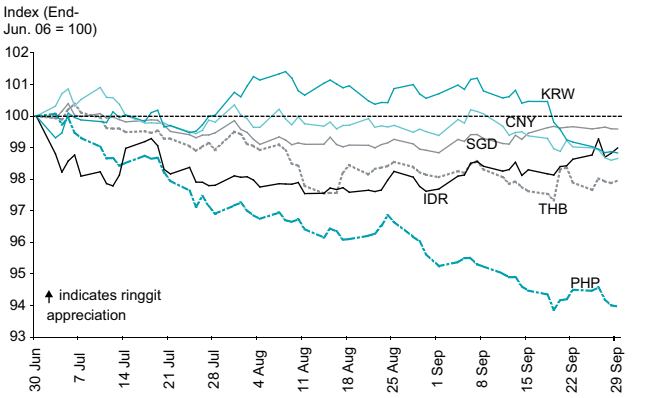
0.4% - 6%. Regional currencies were supported by continued capital inflows into regional equity and high-yielding assets. Regional currencies were also affected by country-specific factors. The Philippine peso, in particular, benefited from continued positive sentiments arising from improved government finances. The Thai baht appreciated over the quarter, despite weakening temporarily in the immediate aftermath of the military coup in September.

During the period 1 October - 21 November 2006, the ringgit appreciated against most of the major currencies, amidst continued trade and investment flows. The ringgit also appreciated against most regional currencies in the range of 0.1% - 0.5%, the exception being against the Thai bath (1.6%) and Singapore dollar (0.9%).

Ringgit Performance Against Major Currencies



Ringgit Performance Against Regional Currencies



Performance of Ringgit Against Selected Currencies

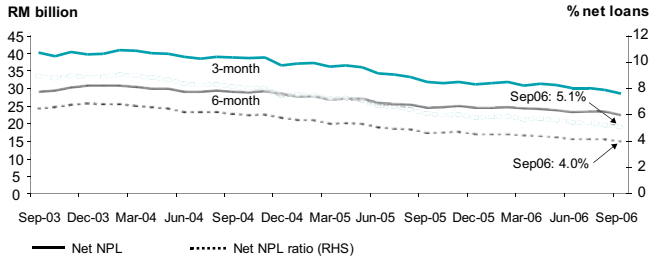
RM per foreign currency	As at end						% change since*				
	30 Jun 97	02 Sep 98	21 Jul 05	3Q 05	2Q 06	3Q 06	30 Jun 97	02 Sep 98	21 Jul 05	3Q 05	2Q 06
US dollar	2.5235	3.8000	3.8000	3.7692	3.6750	3.6845	-31.5	3.1	3.1	2.3	-0.3
Euro	-	-	4.6212	4.5421	4.6698	4.6821	-	-	-1.3	-3.0	-0.3
Pound sterling	4.1989	6.3708	6.6270	6.6438	6.7352	6.9171	-39.3	-7.9	-4.2	-4.0	-2.6
100 Japanese yen	2.2088	2.7742	3.3745	3.3359	3.1963	3.1279	-29.4	-11.3	7.9	6.6	2.2
Singapore dollar	1.7647	2.1998	2.2570	2.2315	2.3126	2.3221	-24.0	--5.3	-2.8	-3.9	-0.4
100 Thai baht	9.7470	9.3713	9.0681	9.1988	9.6104	9.8109	-0.7	-4.5	-7.6	-6.2	-2.0
100 Philippine peso	9.5878	8.8302	6.8131	6.7262	6.9047	7.3477	30.5	20.2	-7.3	-8.5	-6.0
100 Indonesian rupiah	0.1038	0.0354	0.0386	0.0366	0.0395	0.0399	160.2	-11.3	-3.3	-8.3	-1.0
100 Korean won	0.2842	0.2827	0.3665	0.3619	0.3856	0.3901	-27.1	-27.5	-6.0	-7.2	-1.2
Chinese renminbi	0.3045	0.4594	0.4591	0.4669	0.4598	0.4660	-34.7	-1.4	-1.5	0.2	-1.3

* (+) indicates appreciation of ringgit against respective currency and (-) indicates depreciation.

DEVELOPMENTS IN THE BANKING SECTOR

The banking system continued to exhibit resilience and financial strength underpinned by improved key soundness indicators during the third quarter of 2006. Stronger capitalisation and sustained profitability levels were recorded amidst continued downtrend in the level of NPL.

Banking system: Non-performing loans



Capitalisation remained strong on account of higher level of capital base

The banking system remained well-capitalised on account of higher capital base which expanded by 3.1% from the previous quarter. This was mainly attributable to the inclusion of year-end profit by some banking institutions. The RWCR and core capital ratio (CCR) improved to 13.2% and 10.4% respectively.

Banking system: Capital Position

	2005		2006		
	3Q	4Q	1Q	2Q	3Q
Capital					
CCR (%)	10.7	10.7	10.0	10.2	10.4
RWCR (%)	13.5	13.7	13.1	13.0	13.2

Profitability sustained

The banking system recorded encouraging level of pre-tax profit (PBT) totalling RM3.8 billion (+42.2%) on account of higher net interest income (+15%) attained from stronger loans- and financing-related activities (+12.9%), higher net trading and investment income, as well as lower loan loss provisions. For the first nine months of 2006, total PBT improved by 8.1% to RM9.6 billion (Jan-Sep 2005: RM8.9 billion). As a result, the annualised returns on average assets and equity improved to 1.3% and 16.5% respectively (2Q 2006: 1.2% and 15.5% respectively).

Declining trend of banking system NPL level continued

Based on the 3-month classification, the NPL level continued its downward trend as net NPLs declined further by 5.5% to RM28.6 billion (2Q: RM30.2 billion).This was attributable mainly to lower amount of NPL classifications (-8.2%) and higher NPL write-offs (+29.7%) during the quarter. As a result, the net NPL ratio declined to 5.1% (2Q: 5.4%).

MALAYSIA: TRENDS IN DIRECT INVESTMENT ABROAD

I. Introduction

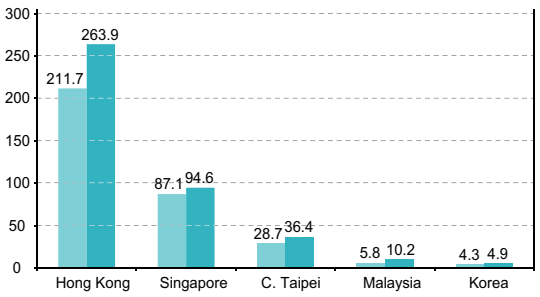
Since 1990s, developing countries have increasingly become significant exporters of capital. In the Asian region, Malaysia is the fourth largest exporter of capital after Hong Kong China, Singapore and Chinese Taipei. Malaysia's stock of outward direct investment rose from a low of 0.8% of GDP in 1980 to 5.8% in 2001, and further to 10.2% of GDP in 2005 (Chart 1). The liberal foreign exchange administrative rules, high domestic savings rates and a history of strong economic growth that led to the rising accumulation of wealth among domestic companies have accorded companies in Malaysia the flexibility to invest abroad. The rising direct investment abroad has yielded positive results, as reflected in the increasing profits and dividends accruing to the Malaysian companies investing abroad, particularly since 2002. This article examines the trend in direct investment abroad[1] by companies operating in Malaysia during 1999-2005 based on Cash Balance of Payments (CBOP) data of Bank Negara Malaysia, which includes the outflows of funds that are effected through the banking system, inter-company accounts and overseas accounts.

II. Overview of Malaysia's Direct Investment Abroad

Direct investment abroad by Malaysia has been broad-based, with companies[2] investing in almost all economic sectors in more than 100 countries. Gross capital outflows for investments abroad ranged between 2% and 4% of GDP during the period 1999-2005 (Chart 2). Investments in the earlier years were undertaken primarily by the government-

Chart 1

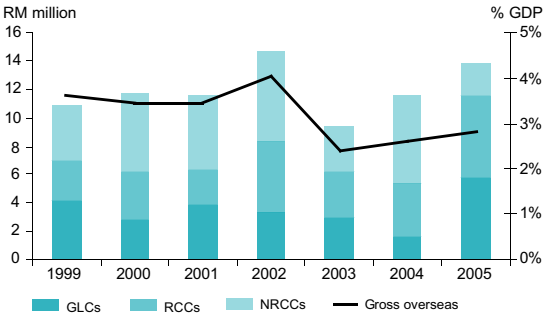
Stock of Outward Direct Investment (% GDP)



Source: National sources; Department of Statistics, Malaysia

Chart 2

Gross Outward Direct Investment Flows



Source: Bank Negara Malaysia

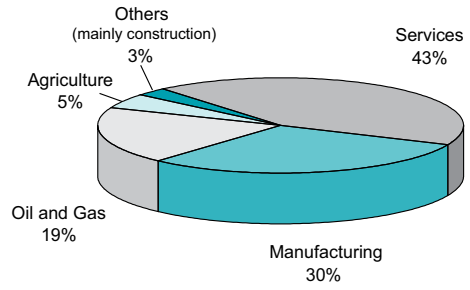
1. According to the IMF's Balance of Payments Manual, Fifth Edition, direct investment abroad is a form of direct investment, whereby companies invest abroad with the intention of obtaining a lasting interest (defined as holdings of at least 10% ownership) in an enterprise resident of another economy. In Malaysia, data on direct investment abroad in accordance to IMF definition are compiled and released on a quarterly basis by the Department of Statistics, Malaysia (DOS), the official compiler of Balance of Payments statistics. The data includes investment in the form of equity, reinvested earnings and other capital (mainly loans). This data differs from the statistics compiled by Bank Negara Malaysia's Cash Balance of Payments (CBOP) Reporting System, which refer purely to outflows of funds in the form of equity and inter-company loans as well as for real estate acquisitions effected through the banking system, inter-company accounts and overseas accounts. For the purpose of compiling balance of payments statistics, capital invested in or loans extended to subsidiaries abroad must be offset against the capital invested in or loans extended to Malaysia by subsidiaries abroad. At present, the CBOP System is not able to segregate this type of transaction.

2. For analysis purposes, companies are classified into GLCs (non-financial public enterprises in which the Government has an equity of more than 50% and with sales turnover of at least RM100 million), RCCs (private companies in which residents have equity stake of more than 50%) and NRCCs (private companies in which total non-resident shareholding is more than 50%).

linked companies (GLCs), seeking access to natural resources such as oil and gas as well as in the agriculture sector. However, in recent years, private non-GLC companies have become increasingly active overseas investors. These investments have been driven by a variety of reasons including securing market access; gaining access to raw materials, strategic assets, brands and technology; as well as decentralisation of operations to diversify risks and improve returns. The emergence of the new low-cost economies has also provided options for companies with high labour-dependency to restructure and realign corporate operations on a global scale to remain competitive. While Malaysia continues to encourage and attract FDI into the country, the Government is also playing an active role to facilitate companies' initiatives to venture abroad. The Malaysian government has embarked on several collaborative measures with other governments to expand and deepen economic and industrial co-operation via bilateral arrangements as well as through negotiations for Free Trade Arrangements. Thus, over the years, the scope of Malaysia's investment abroad has broadened from just the oil and gas explorations and extractions and oil palm plantations to other industries, including telecommunications, banking and finance, infrastructure and property development, manufacturing, power generation and retail-related industries (Chart 3).

Chart 3

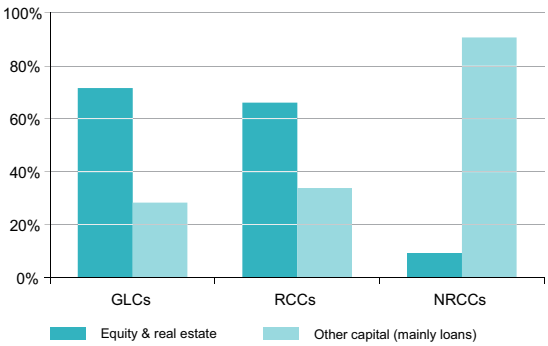
Outward Direct Investment by Sector (1999-2005)



Source: Bank Negara Malaysia

Chart 4

Outward Direct Investment by Type (1999-2005)



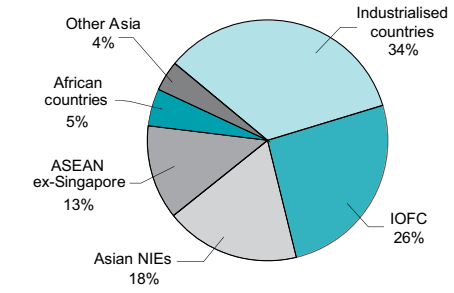
Source: Bank Negara Malaysia

Outward direct investments by the Malaysian-controlled companies (GLCs and resident-controlled companies, RCCs) were undertaken mainly via acquisition of equity stakes and joint-ventures with foreign partners abroad, including investment in greenfield projects (Chart 4). The bulk of these investment flows (around 70%) were for equity investment and real estate acquisition. Meanwhile, the bulk of the non-resident controlled companies' (NRCCs) investments were in the form of extension of inter-company loans (90%) to related corporations abroad. Despite the differences in the mode of investment, most of the companies were prudent in financing their overseas ventures. Internally-generated funds financed the bulk of NRCCs' overseas investment, while investments by RCCs and GLCs were sourced mainly from internal funds (62%) and offshore borrowings (26%).

In terms of geographical distribution of overseas investments, most of the investments were channelled to the more developed economies such as the industrialised countries (34%) and Asian NIEs (18%) (Charts 5 and 6). Investment in the developing economies were conducted primarily by the GLCs and RCCs, with the bulk of the investments being channelled to the ASEAN and African regions as well as selected countries in other parts of Asia (such as PR China, India, Sri Lanka, Pakistan and some West Asian countries). Compared with the other destinations, investments to the developing economies registered the highest growth rate (25%), with its share of total investment rising significantly from 13% in 1999 to 31% in 2005. There were also significant investment outflows to the international offshore financial centres, IOFCs (26% share), including Labuan IOFC, where investible funds were pooled before redirected to other economic sectors in various locations in the world.

Chart 5

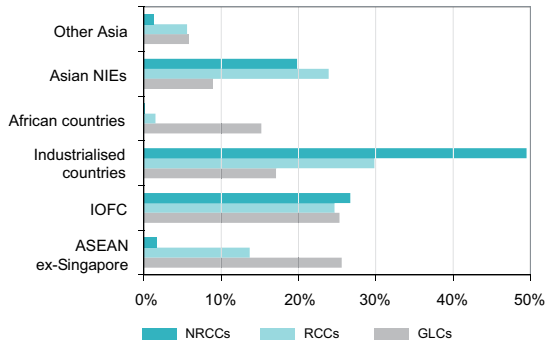
Outward Direct Investment by Region (1999-2005)



Source: Bank Negara Malaysia

Chart 6

Outward Direct Investment by Region and Type of Investor (1999-2005)



Source: Bank Negara Malaysia

III. Investment Trends of Malaysian-Controlled Companies

Investments by both private RCCs and GLCs together accounted for 61% of total gross outflow of funds for direct investment abroad during the period 1999-2005. The bulk of the investment was effected by companies in the services sector (48%), followed by mining (31%), agriculture and manufacturing sectors (8% each). The GLCs were the dominant investors in the oil and gas, and the telecommunication industries, while the RCCs were the main driver for investments in the manufacturing, utilities, distributive trade, leisure, plantation, construction as well as banking and finance industries.

Within the **services** sector, investment in the finance, insurance and business services sub-sector was the largest (43%), followed by transport, storage and communications (20%), utilities (20%), and distributive trade, hotels and restaurants (12%). Investments in the ***finance, insurance and business services*** sub-sector reflected to a large extent, activities of investment holding companies that were set up in IOFCs to centrally manage global investment operations. In addition, several

financial institutions have also ventured abroad to gain a foothold in the regional or international stockbroking and investment banking businesses. Investment in the ***transport, storage and communications*** sub-sector was conducted mainly by companies in the telecommunication industry, via acquisitions and joint-ventures with foreign telecommunication companies from diverse locations including Indonesia, Thailand, France, Sri Lanka and Bangladesh. These investments were motivated particularly by the enormous growth potential given the largely untapped markets in some of these countries. In the ***utilities*** (electricity, gas & water) sub-sector, major investments included the acquisition of regulated assets such as water services companies and power plants abroad. The national power company has also set out and initiated joint-venture partnerships in power projects across Asia as one of its initiatives to strengthen the ASEAN power grid through the optimisation of regional resources.

In the ***wholesale and retail trade, hotels and restaurants*** sub-sector, a significant portion of outward investment was in the distributive trade and hotel industries. The bulk of the investments went to the industrialised countries and the East Asian region, given the anticipation of a strong and improving growth outlook in those economies. This was further supported by the positive demographic attributes and rising incomes of the population which would provide a lucrative set of expanding customer base. Wholesalers that invested abroad specialised mainly in electrical and electronic (E&E) products, building materials, miscellaneous agriculture products such as rubber and timber, while retailers comprised largely those selling general merchandise, computer hardware and software and various household products.

Malaysia's investment abroad in the **mining** sector was conducted primarily by the national oil company, a GLC. Underpinned by the vast knowledge and experience in the domestic oil and gas exploration and extraction activities, and the anticipation of higher global energy demand, the company embarked on a strategy of global diversification and expansion. The successful global upstream ventures have also boosted the company's revenue and international oil and gas reserves. During the period 1999-2005, the company has made petroleum-related investments in many locations in Africa, West Asia, industrialised and ASEAN countries. The investments were mainly for upstream oil and natural gas exploration and extraction activities, largely undertaken jointly with national oil companies in the host countries.

Meanwhile, investments in the **agriculture** sector were largely for oil palm plantations. For more than a decade, Indonesia has been and continued to receive a large share of investments from Malaysia for oil palm cultivation. Given the rising demand for palm oil products globally, and with Malaysian companies' experience and technical capabilities in plantation management and production of crude palm oil, companies are expected to continue venturing abroad to acquire plantation land to augment their total acreage to reap the benefits of economies of scale.

In the **manufacturing** sector, many private RCCs, which originally entered foreign markets as exporters, have increasingly evolved into manufacturers abroad, seeking investment opportunities that will maximise value within their risk-return framework globally. Manufacturing investments abroad were concentrated in three main industries, namely

fabricated metal products, machinery and equipment (48%); food, beverages and tobacco (14%); and chemicals and petroleum-related industry (10%). Industrialised countries and Asian countries received the bulk of investments in the ***fabricated metal products, machinery and equipment*** group, which comprised industries that manufacture electrical appliances and household equipments (e.g. radio, television, semiconductors and other electronic components), and industries related to transport equipment. Companies in the ***food, beverage and tobacco industries*** also invested in the industrialised countries and the East Asian region although some, such as sugar factories and refineries preferred to go through the IOFCs. Meanwhile, investments in the ***chemical and petroleum-related industry,*** in particular plastic products, rubber and chemical-related industries were concentrated in the ASEAN region, with Thailand, Indonesia and Vietnam as key countries.

Manufacturers' investments abroad were underpinned by many reasons, but the E&E manufacturers were attracted mainly by the opportunity to be low cost producers abroad. Thus, the companies adopted the multinational companies' strategy of hiving off and relocating their resource-intensive operations into low-cost locations abroad to maintain product competitiveness. Other companies which have acquired interest in or formed joint ventures with foreign counterparts abroad were able to scale up the production value chain and also have an integrated supply chain management. The desire to acquire physical assets such as manufacturing facilities, high technology and management expertise, brands and trademark rights to established products or vital resources were also the driving force for the companies to venture abroad. To seize the advantage of being in close proximity to clients and markets, companies in the food and beverage industry set up their factories in high-growth developing economies, capitalising on cheap resources and sustained high demand for processed food in tandem with the general rise in income.

Meanwhile, Malaysian **construction** and property development companies have been making inroads abroad. Motivated by the need to search for new revenue sources outside Malaysia, their investments have been broad-based ranging from acquisition of construction companies particularly in UK and Hong Kong China, to infrastructure concession and property development projects in the developing economies of Asia and Africa, particularly in India, South Africa, PR China, Cambodia and Indonesia. Backed by a good track record and expertise in civil engineering and property development and management, these Malaysian companies have, despite intense competition, successfully secured large development projects such as road, bridge, port and airport development as well as other smaller scale projects like residential and urban townships, and other development projects in the water, oil and gas sectors.

IV. Investment Trends of Non-Resident Controlled Companies

During the period 1999-2005, about 39% of total gross outflows of funds for investments were attributed to the NRCCs. Nevertheless, the share of NRCCs to total investment flows has declined over the years from 35% of total overseas investment in 1999 to 17% in 2005, due largely to the increased participation of GLCs and private RCCs in overseas investment. The bulk of investment outflows by NRCCs were in the form of inter-company loans to related companies abroad (91% share), attributed mainly to the excess funds generated from their successful operations in Malaysia. Companies in the **manufacturing**

sector accounted for more than 60% of investment flows. Within the manufacturing sector, most of these loans were extended to the related companies in the manufacturing of semiconductor and other electronic component industry (53%) and the manufacturing of radio, television sets, video recorder and other equipment industry (20%). The bulk of these outflows were channelled to the US, Singapore and Belgium.

V. Policies Concerning Direct Investment Abroad

Malaysia maintains a liberal regime on overseas investment. Prior to the Asian crisis, residents without domestic borrowing can freely remit any amount in foreign currency for overseas investment, while individuals and corporate groups with domestic borrowing were respectively allowed to invest abroad up to the equivalent of RM100,000 and RM10 million per calendar year. Where approval was required, the investment must bring economic benefits to Malaysia such as assisting Malaysia to gain market access, encourage use of Malaysian inputs (raw materials, parts and components), assist in exporting Malaysian products or services and/or involves transfer of technology and know-how to Malaysia. During the period following the Asian crisis, the policy stance remained liberal although there was requirement for resident investors to obtain prior permission. In April 2005, the rules regarding overseas investment were further relaxed, and overall, the guidelines were more liberal than those prevailing prior to 1 September 1998. Resident companies with domestic borrowing are allowed to invest abroad using foreign currency funds maintained in Malaysia or offshore. In addition, resident companies are also allowed to hedge the foreign exchange risk of their existing and new overseas investments.

Equally important, investments abroad were also facilitated by the Malaysian government's active participation in regional and international fora to deepen economic and industrial co-operation. Other initiatives include the provision of fiscal incentives as well as non-financial support, such as advisory and consultancy services for securing construction projects abroad. The recent Budget 2007 also outlined some measures to help create Malaysian-owned MNCs with global operations. These include an increase in the paid-up capital of EXIM Bank by RM2 billion by the Government to enhance the bank's role in providing financing for domestic companies investing abroad and the setting up of a RM100 million Overseas Investment Fund to finance start-up costs of domestic companies doing business overseas. In addition, Bank Negara Malaysia has also set up a RM1 billion Overseas Project Financing Fund at the EXIM Bank in 2006 to assist Malaysian companies bidding and securing contracts overseas to have greater access to financing in undertaking their projects abroad.

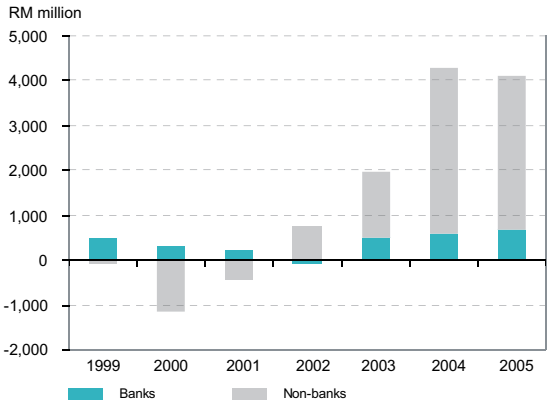
VI. Benefits from Overseas Investment

Given that overseas investment is a long-term investment, conducted in less familiar terrain and subjected to various external risks, such as change in government policies (including ownership laws), exchange rates movements, adverse weather conditions, sudden political changes and competition with international and domestic market players in the host country, the returns on investments would only be realised over a longer timeframe.

Total profits, dividends and interests accrued to Malaysian companies that have invested abroad grew from RM0.4 billion in 1999 to RM4.1 billion in 2005 (Chart 7). The improvement reflected mainly the sharp recovery in profit and dividends accrued to the non-bank sector, while profits and dividends accrued to the banks remained stable. Overall, total direct investment income earned accounted for about 26% of total investment income inflows (which include portfolio and other non-FDI investments) in 2005.

Chart 7

Profits and Dividends



Source: Department of Statistics, Malaysia

VII. Conclusion

Going forward, overseas investments would continue to increase in line with the long-term economic trend whereby increasingly affluent economies would progressively look beyond their shores to augment domestic economic growth and assets. This would be further supported by forces of globalisation and greater liberalisation of investment rules globally. For Malaysia, the Government would continue to adopt a positive stance towards overseas investment, both to support the interest of freer capital mobility and to improve the overall competitiveness of Malaysia corporations. For the corporate sector, opportunities beyond national borders are abundant and overseas investment would be increasingly regarded as an important strategy to maximise company's total growth in terms of revenue, profit and export market share.

The Malaysian Islamic Finance Issuers and Investors Forum 2006
14 August 2006, Kuala Lumpur

Keynote Address by

Tan Sri Dato' Sri Dr. Zeti Akhtar Aziz
Governor, Bank Negara Malaysia

It is my great pleasure to be here today to speak at this Malaysian Islamic Finance Forum that has been the joint efforts by the key regulatory and market authorities in the financial services sector in Malaysia, that includes Bank Negara Malaysia, the Securities Commission, Labuan Offshore Financial Services Authority (LOFSA) and Bursa Malaysia. The aim of this forum is to provide a platform for industry players and regulators to interact and discuss recent developments in Islamic finance in Malaysia, the performance of the Islamic financial market, and to provide greater awareness on the innovative products and services and the opportunities for both issuers and investors.

The rapid pace of development of Islamic finance in Malaysia has taken place in an environment of strengthening economic growth that is underpinned by strong fundamentals. The growth has been achieved with relative price stability, low unemployment and a strong external balance. The level of savings remains high and external reserves are at a comfortable level at about USD80 billion. Meanwhile, GDP per capita in current prices has increased by an average of 7.1% per annum since 1991 to about USD5,000 in 2005. And if adjusted for the cost of living the purchasing power parity (PPP) adjusted GDP doubled over the period to USD10,318. The sustainability of the economic growth momentum has been derived from the diversified economic structure that has evolved, as the flexibility of the economy has yielded the continuous ability to shift to new areas of comparative advantage. It is this diversification in the economy that has also reduced vulnerability to shocks and increased resilience.

Malaysia has also taken advantage of globalisation to strengthen its economic and financial relationships with the major trading blocs in the world. This year we expect our trade value to exceed **RM1 trillion** for the first time. Foreign direct investment has been sustained, in particular, into the new areas of growth. There has also been an increase in Malaysian corporates and financial institutions venturing abroad. This has strengthened our inter-linkages in the global economy and our integration in the international financial system.

Amid the environment of favourable growth and strong fundamentals, Malaysia has taken the opportunity to further deregulate and liberalise the Malaysian financial sector, with a view to enhancing its contribution to efficiency and growth. The sector has also continued to be progressively transformed through rationalisation amongst existing financial institutions and the introduction of new institutions. These developments have contributed to the strengthening of the international dimension in the financial system. This has been particularly the case for the Islamic finance sector. In the development of the Islamic financial system, the Islamic Banking Act 1983 of Malaysia accords universal banking stature to licensed Islamic banks. The banks are permitted to conduct the full spectrum of banking business, including the more sophisticated investment banking activities such as corporate finance, private equity and wealth management. It is innovations in product development in this particular sector that has paved the way for increased opportunities in the Islamic financial system.

The Malaysian Islamic banking system saw strong performance in 2005, with higher profitability and positive trends in all key indicators. Profitability surpassed the RM1 billion mark for the first time in 2005, and assets surpassed the RM100 billion mark. The Islamic banking sector has remained well capitalised with the risk weighted capital ratio sustained above 12 percent. The most recent performance of the Malaysian Islamic financial market has been encouraging with Islamic banking assets amounting to RM117.4 billion, takaful assets of RM6.2 billion, and Islamic corporate bonds of RM125 billion, which constituted 46 percent of the total corporate bond market in Malaysia. A total of 26 new corporate sukuk issues with an aggregated value of about RM23 billion were announced in the first half of 2006. This is equivalent to 71 percent of the Malaysian domestic market's rated corporate bond issues for the same period. This increase in critical mass reflects the demand for issues, providing the supply for investors.

Let me now touch on several important aspects of the Malaysian Islamic financial markets that are important to issuers and investors. These relate to the freedom to move capital into and out of Malaysia, the availability of credible and timely market information and the capacity of the Malaysian Islamic financial market to allow for greater product diversification and risk management.

On capital mobility, Malaysia maintains a highly liberal foreign exchange administration regime. The primary focus of foreign exchange administration is to support the monitoring of flows of funds to promote financial and economic stability. As part of the continuous effort to enhance efficiency and reduce the cost of doing business, the foreign exchange administration rules have been progressively liberalised and simplified. There is free mobility of inward and outward movement of funds relating to both foreign direct investment and portfolio capital investments. Foreigners investing in Malaysia are also free to hedge with onshore banks their committed flow of funds such as the repatriation of investment proceeds, dividend and profits from Malaysia as well as the purchase of ringgit assets in Malaysia. In addition, investors are freely able to obtain ringgit and foreign currency to fund their investments in Malaysia.

Strategic measures have also been taken to allow non-residents, in particular, Multinational corporations and Multilateral agencies to issue ringgit denominated bonds in Malaysia. The ringgit funds raised may be used either in Malaysia or outside Malaysia. Both the foreign issuers and investors are free to hedge their foreign exchange exposure from the issuance and interest respectively. There is no withholding tax on the profit realised from investments in these ringgit denominated bonds. The International Finance Corporation and the International Bank for Reconstruction and Development have since issued their first ever Islamic bond issuances in Malaysia. The total issuance amounted to RM1.3 billion, all of which were over subscribed. A portion of these papers was purchased by non-resident investors, indicating foreign interest in the ringgit denominated instruments.

On the availability of credible and timely information, the Malaysian regulatory framework, reinforced with the adoption of best practices, has created an environment of greater transparency and richness in financial market information. The financial regulators provide extensive information about the Malaysian economy and Malaysian financial system, including regulatory requirements. The Bank also has put in place several websites that provide market information on the issues that are available for the market participants. Finally, on the capacity for diversification and risk management in the Islamic financial system, while being relatively small compared to the conventional system, it is expected to expand as the financial system strengthens and as new products are introduced.

In the context of this financial infrastructure, the Malaysian Islamic financial

system is both robust and fast growing. The market has highly diversified players, with Islamic banks, investment banks, takaful companies, development financial institutions, savings institutions, fund management companies, stock brokers and unit trusts. The Malaysian Islamic financial market has already introduced a variety of Islamic financial hedging instruments, including the Islamic profit rate swap, Islamic cross-currency swap and Islamic forward rate agreement. The wider use of commodity murabahah transactions will also add breadth and depth to the Islamic money market as it facilitates a more efficient distribution of money-market liquidity and expands the range of instruments that market participants can actively transact in.

We are pleased to announce that Bank Negara Malaysia will soon be adding murabahah-based transactions to our already diverse range of policy instruments to manage short-term liquidity in the Malaysian Islamic inter-bank money market. The Bank Negara Malaysia's murabahah based-transactions may either utilise global or Malaysian commodities as the underlying transaction, and in the future, other Shariah-approved assets similar to the Ijarah sukuk notes. The widespread usage of this globally practised financing instrument would allow market participation by a more extensive investor base, including those from the Middle-East.

Product innovation must be a continuous and deliberate part of the process of market development. We are therefore firmly committed to developing the capabilities in Islamic finance and strengthening the global pool of talent and expertise in Islamic finance to increase the potential for this to happen. As part of the initiative to meet this objective, we have established the International Centre for Education in Islamic Finance, INCEIF, in March this year to offer professional certification programs in Islamic finance, in addition to, Masters and Doctorate programs. Bank Negara Malaysia has also recently made available a Shariah Scholarship Award and Shariah Research Grant, available to Malaysian and non-Malaysians seeking to pursue research studies in Islamic finance.

East Asian, West Asian and the Middle East Regions : Greater Inter-linkages

Islamic finance has made significant inroads in the international financial markets in that it has achieved growing global awareness. Islamic finance now has a presence in over 60 countries, with total Islamic assets under management by Islamic banks and conventional banks offering Islamic banking services reportedly exceeding USD400 billion. At present, Islamic mutual funds are estimated to be at a value of over USD300 billion, while issuance of Islamic sovereign and corporate bonds, or sukuk, have reached about USD50 billion. Islamic finance has demonstrated its viability and competitiveness in the current environment of a more liberalised and globalised financial system, with changing business and technological climates. As a form of financial intermediation it is now becoming increasingly integrated with the international financial system.

Against the backdrop of this rapid development in the international Islamic financial markets, there is potential to build greater intermediation linkages between the East Asian, the West Asian and Middle East regions to expand further the inter-regional trade and cross border investments. In an increasingly globalised financial environment, sovereigns, development institutions and corporations of capital deficit countries have the option of raising Islamic financial instruments in capital surplus countries through the Islamic financial intermediaries. Significant economic benefits will arise from the strengthening of these inter-linkages.

The expansion of inter-linkages of intermediation and markets among these regions would lead to a more efficient allocation of capital and thus enhance the prospects for strengthening further the growth performance. It also offers enhanced opportunities for raising financing and would also facilitate greater risk diversification. In

particular, the strong growth performance in these regions create a significant potential demand for financial instruments that conform to the Islamic injunctions. These dynamic regions can therefore be expected to contribute towards accelerating the expansion of Islamic finance in the international financial system. Indeed, these trends will also contribute towards promoting a more balanced global growth.

The participation in the Islamic finance intermediation process would require the development of a comprehensive and well established Islamic financial system, a wide range of products and services; a good legal system, adequate financial infrastructure with competitive tax structures, low cost of doing business, high standards of business ethics, and conducive living conditions and cultural offerings. It would also need to be supported by adequate human talents that would drive the business and spur innovation. In addition, a strong regulatory regime in the Islamic financial system would be another pull factor. More recently, the regulatory regime in Islamic finance has been further reinforced by rapid progress on the issuance of prudential and supervisory standards by the Islamic Financial Services Board (IFSB). Fund raising, investments and risk diversification are essentially complex transactions. These transactions are highly dependent on financial markets that are well regulated and capable of evolving to meet the emerging new challenges and the changing market needs. Finally, the potential for the markets to function efficiently would be enhanced if the financial market is developed in an environment that enjoys financial stability, monetary stability and sustained economic growth.

The MIFC initiatives

To enhance the inter-linkages in the global Islamic financial markets, Malaysia is continuing its efforts to not only develop further the Islamic financial infrastructure but to also implement measures and initiatives that will strengthen our position as an international Islamic financial hub.

The Malaysian Government is therefore launching an initiative known as the Malaysia International Islamic Financial Centre or MIFC. The MIFC initiative is specifically undertaken by the collective efforts of the country's financial and market regulators, including Bank Negara Malaysia, Securities Commission, LOFSA and Bursa Malaysia, together with the participation of the industry representing the banking, takaful and capital market in Malaysia. As part of the initiatives, Islamic financial products and services that are transacted in international currencies may now be conducted **from anywhere in Malaysia**. Malaysia has the physical infrastructure, international connectivity, the communication network, cultural offerings as well as the talents which is inherently advantageous to the MIFC.

In this first phase, the MIFC initiative will introduce measures and incentives to promote the centre in the offering of Islamic financial products and services by the diversified range of financial institutions in international currencies to the international and domestic financial community. The key measures and incentives include:

i. Firstly, the Malaysian Islamic banks and takaful operators that are offering Islamic financial services in international currencies will be granted approval under the existing licence to set up **International Currency Business Units** within the institutions. These new divisions will have their own accounts separate from the ringgit transactions of the head offices, while at the same time sharing the same infrastructure with the head offices. This division may benefit from tax and other incentives that may be introduced.

   This measure will apply to the Islamic banks and takaful operators licensed under the Islamic Banking Act and Takaful Act respectively to operate in the Islamic financial system as well as to the existing financial institutions which are eligible to participate in the

Islamic financial services. This is also expected to enhance the capability of the foreign players that have identified Malaysia as their centre to serve the regional markets. International entities will also be able to participate via foreign interest of up to 49 percent in Islamic banks and takaful companies. Investment funds set up in Malaysia will be able to enjoy the Double Tax Agreements that Malaysia has entered into with over 60 treaty partner countries.

ii. Second, Bank Negara Malaysia will issue new **conditional licences under the Islamic Banking Act** to qualified foreign and Malaysian financial institutions to conduct the full range of Islamic banking business in international currencies and enjoy the same **tax incentives** as those accorded to the International Currency Business Units. The new entity will be termed **licensed International Islamic bank**.

The business that the licensed International Islamic bank would be allowed to undertake includes the wide-ranging business of Islamic commercial banking, Islamic investment banking and Islamic leasing in international currency.

iii. Third, Bank Negara Malaysia will also issue new **conditional registrations under the Takaful Act** to qualified foreign and Malaysian insurance companies to conduct the full range of takaful business in international currencies. Similar **tax treatment** will be accorded to these entities as that for the banks. The new entity will be termed **International Takaful Operator.**

iv. Fourth, the Labuan offshore Islamic banks and the Islamic divisions of the offshore banks as well as offshore takaful operators will be given greater flexibility in their business operations by allowing the **opening of operational offices anywhere in Malaysia** with no limitation on staffing, to conduct non-ringgit business while maintaining their presence in Labuan. This measure would be accorded to the six existing offshore Islamic banks and Islamic investment banks operating in offshore centre Labuan to participate in the MIFC.

v. Fifth, incentives will be given **to attract the best foreign talents and market players to the MIFC** to spur innovation and offering of attractive Islamic financial instruments. This is to further strengthen the large pool of highly trained workforce with vast experience in Islamic finance already in Malaysia. Further incentives will also be introduced to spearhead the aspiration of developing Malaysia as a **centre of education excellence in Islamic finance** to complement the MIFC.

vi. Sixth, in the pursuit of this national agenda, an **MIFC Executive Committee** comprising heads of relevant Ministries, agencies and industry representatives has been set up as a single coordinating committee to efficiently and effectively act collectively in the implementation of the recommendations. The Committee is entrusted to provide direction as well as review existing policies for the comprehensive and coordinated promotion of MIFC, and to align the role and responsibilities of the respective parts of Government and the industry to the development of MIFC. The secretariat is Bank Negara Malaysia, which will act on behalf of this committee as a **one-stop body** to fulfil this task.

We believe that these measures and initiatives will serve as a catalyst in our efforts for Malaysia to become a centre of origination, issuance and trading of Islamic capital

market and treasury instruments, Islamic fund and wealth management, international currency Islamic financial services, and takaful and retakaful business. It is also aimed at positioning Malaysia as the gateway for tapping investment opportunities in this rapidly growing region.

In this environment, financial players, particularly with investment banking and fund management expertise, would need to sharpen their strategies and intensify their efforts in structuring cutting-edge Islamic investment instruments and in attracting new funds. Investors, especially those from the Middle East have shown strong interest to invest in Malaysian assets and to become partners with our local business corporates. There are therefore significant opportunities to strengthen trade and investment ties with the Middle East region. In respect of acceptable Shariah interpretation and practices, the MIFC will adopt a policy of mutual recognition and accommodate the various juristic reasoning based on contemporary analysis and logical inference so long as it is approved by recognised Shariah advisers. Harmonisation and knowledge sharing in Shariah is expected to be further enhanced with the on-going Shariah dialogues for the regional and international Shariah communities that are held annually in Malaysia.

The gathering of so many practitioners here for these two days to discuss the wide ranging matters that concern issuers and investors will contribute to developing our collective understanding of these issues and expand the boundaries of our knowledge. In closing, I wish to say that the motivation for advancing our mission to position Malaysia to become increasingly more integrated with the international financial system is to contribute towards facilitating greater cross border flows in terms of increased intra-regional trade and investment transactions. With the strengthening of intra-regional trade and investment flows, the greater regional economic and financial inter-linkages would contribute towards raising the prospects for more balanced global growth and greater shared prosperity.

The 2006 Dialogue Session with Insurers and Takaful Operators 22 August 2006, Kuala Lumpur

"Strategic Positioning in a Changing Environment"

Keynote Address by

Tan Sri Dato' Sri Dr. Zeti Akhtar Aziz
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In a rapidly changing environment, rethinking the future and strategic repositioning needs to be a high priority agenda. Strategic positioning is not only necessary to deal with the new emerging challenges but more importantly, it needs to be part of the process that will shape the future.

The changes taking place are on several fronts.

- Nations are becoming increasingly inter-linked and integrated in a more globalised environment.
- The Malaysian economy continues to experience significant structural shifts into new areas of growth and comparative advantage.
- Consumers are becoming increasingly discerning in terms of the range and quality of financial products and services.
- The financial system is transitioning into a more competitive environment as institutional arrangements become increasingly more deregulated and liberalised.
- Technological advancement has enabled greater innovation in the development of financial products and services, operational processes and delivery channels.
- The regulatory and supervisory approaches to maintaining financial stability are becoming more principle and risk-based.

With these changes intensifying, it is timely to reflect on the emerging issues for the insurance and takaful industry.

It is my pleasure to welcome you to this year's dialogue session between Bank Negara Malaysia and the insurance and takaful industries to discuss the challenges and opportunities the changing environment presents. A year ago, the focus of the discussions was on the strategic issues facing the industry as we transitioned towards a more competitive market environment. The emphasis was on the expectations on the industry to deliver a fair proposition to consumers, its relevance in the changing environment and its readiness in terms of capacity, and to support and sustain a successful strategy for growth. While the theme for this dialogue is to focus on how the industry should position itself to meet the new challenges, it will specifically address the transition towards a risk-based and a more self-regulated market conduct regime, and the development of a dual financial system for the insurance and takaful industry.

This year, the dialogue has been jointly organised by the industry with the Bank. The industry's active involvement will be important in making this important event a success. This dialogue will provide an opportunity for deliberations on the strategic issues confronting the industry in the changing environment from the different perspectives between the industry and Bank Negara Malaysia. At this juncture, let me take this opportunity to share with you some of the recent economic and financial developments and the major policy initiatives by Bank Negara Malaysia.

The global economic performance for 2006 has so far been favourable with a more balanced growth among the major economies, including in Japan and Europe. The world economy is however, facing an extended period of high energy prices and its consequent effects on inflation. Following these developments, interest rates have been raised in most economies. While risks are now emerging for a slower growth in a number of the major economies, growth in the Asian economies have continued to remain robust and resilient. This trend has not only increased Asia's relative significance in the world economy but it has also contributed to a more balanced global growth.

The Malaysian economy has benefited from this favourable external environment. Growth has been supported by both the strengthening exports performance that has been reinforced by strong domestic demand. Domestic demand also continues to be driven by the private sector as private consumption and investment have been an important source of growth. The continued expansion in private investment is particularly important in ensuring the long-term sustainability of the growth.

The focus of the monetary policy in this environment continues to be towards achieving macroeconomic stability. More recently, the higher energy costs have resulted in an increase in consumer prices. In this environment, interest rates have been raised three times. In May this year, a pause in this increase was announced. With limited evidence of demand induced inflation, the assessment is for inflation to moderate in the second half of this year. In addition, the extent to which the external environment will be affected by the higher energy prices and rising interest rates, and its implications on our domestic economy, will be important considerations in the future direction of interest rates. The risk to higher inflation and to the growth prospects will be carefully balanced. Monetary policy will continue to promote sustainable growth in an environment of price stability.

Since the dialogue a year ago, the financial landscape continues to be transformed. The domestic financial industry has seen further rationalisation and consolidation in the banking groups in retail banking and investment banking. While the rationalisation in the retail banking industry would benefit from the economies of scale, reduce duplication of resources and promote cost efficiency, the new investment bank framework is expected to bring about the emergence of more effective, efficient and resilient capital market intermediaries. It will essentially result in the consolidation of 32 entities into 16 investment banks by the end of this year. Another significant development in 2005 was the establishment of the Malaysian Deposit Insurance Corporation which will further strengthen the domestic financial infrastructure by providing an explicit guarantee of deposits, while simultaneously reinforcing incentives for the improvement of risk management practices by banking institutions. To promote greater financial inclusion in our financial system, development financial institutions have also been strengthened to ensure that they are more focused and complementary in their objectives and business strategies. A major initiative during the year was to promote increased access to financing to the new areas of growth as well as to small and medium scale enterprises, including for micro enterprises. This aims to enhance the potential and capacity of domestic indigenous enterprises to grow and thus enhance their contribution to the economy.

In the area of Islamic banking and finance, policy initiatives have been implemented to position Malaysia to become a leading international Islamic financial centre. Earlier this month, the Malaysian Government had launched the Malaysia International Islamic Financial Centre or MIFC initiative. This initiative is aimed at building greater intermediation linkages between the East Asian, the West Asian and Middle East regions which will in turn, further expand inter-regional trade and cross border investment flows. This would also contribute towards a

more efficient allocation of capital and thus enhance the prospects for mutually reinforcing intra-regional growth. In addition, the enhanced opportunities for raising financing offers would also facilitate greater risk diversification. To achieve this goal, efforts and resources are being directed towards achieving two broad objectives:

- First, to become an international leader in the origination, issuance as well as trading of Islamic capital market and treasury instruments, fund and wealth management services, offshore Islamic financial services, and takaful and retakaful.

- Second, to position Malaysia as a centre of excellence for Islamic banking and finance education, training, consultancy and research. This will not only provide an extensive pool of highly trained and capable expertise to spearhead future development, but will also promote greater innovation in Islamic financial products and services.

Given the functioning of Islamic finance in parallel with the conventional financial system in our financial environment, neutrality in treatment between Islamic and conventional finance products is important to ensure its viability and sustainability. This competitive environment would in fact encourage greater innovation to take place, thereby supporting the development of the Islamic financial services industry. With the much strengthened and more robust Islamic financial infrastructure that is now firmly in place, the Islamic financial services industry is well positioned to tap new growth opportunities to realize its full potential. This will inevitably increase the breadth and depth of the Islamic financial markets and, more importantly, strengthen Malaysia's position as an attractive and dynamic international Islamic financial centre.

The Bank's regulatory orientation in this changing environment continues to evolve towards a more robust and flexible regime to effectively maintain financial stability. The regulation of the financial services industry in the changing environment will continue to focus on safeguarding the financial system against systemic risk, ensuring the reasonable protection of consumers in financial service dealings and enhancing the efficiency of the financial system. In addition, the regulatory function will also continue to facilitate the achievement of the socio-economic objectives, including increasing the insurance penetration, promoting adequate provision for retirement needs and supporting the growth of target sectors.

While these objectives will provide the basis and direction for regulation, it is recognised that the environment in which financial institutions operate has changed significantly. Accordingly, the regulatory practices have undergone significant change in recent years to ensure that they continue to be aligned with the underlying rationale for regulation. More specifically, the Bank's approach to regulation is increasingly characterised by:

- a heightened focus on, and alignment with, risk;

- anticipatory, rather than reactive interventions;

- greater use of incentives to achieve desired institutional behaviours and outcomes; and

- convergence with international best practices.

Efforts have also been directed at achieving regulation that is more proportionate in relation to its costs and benefits. This has resulted in an expanded regulatory toolkit that is now beyond prescriptive rules, but leveraged more extensively on inherent checks and balances within the system, and on the greater use of incentives to achieve desired institutional behaviours and outcomes. In addition, there has been an increased focus on market conduct and harnessing more

active consumerism to reinforce prudential regulation and supervision.

To further reinforce these changes, the Bank has undertaken a holistic review of the regulatory and supervisory structures within the Bank. The internal organisational changes that are being made will result in a complete transition from the current approach to regulation on a sectoral basis, to one that will integrate the Bank's regulation of different financial institutions under its purview along functional lines. In effect, the existing regulatory departments will be transformed into new departments with respective responsibilities for financial sector development, prudential policy, consumer protection and market conduct, and financial surveillance across both the banking and insurance sectors. The supervisory functions will similarly be integrated for financial service groups that include both banks and insurance companies under their umbrella.

We believe this organisational change will deliver a more comprehensive overview and cohesive approach to the development of the financial system, while facilitating a clear distinction between the objectives of prudential regulation and financial stability, and the broader developmental objectives. It will also sharpen the regulatory focus on the management of risk in the financial system in a manner that will more effectively address the basic components of credit, market, operational and insurance risks. For the regulated institutions, this new structure is also intended to promote greater efficiency and competition in the financial system by:-

- minimising regulatory overlaps and duplication within the system;
- preserving regulatory neutrality in the management of similar risks between different financial service providers; and
- ensuring more efficient use of regulatory resources.

The Bank will be communicating the details of the new structure to the licensees in November and December this year. A smooth transition will be ensured to maintain continuity in the major ongoing regulatory initiatives currently being undertaken by the Bank, and clear arrangements will be made for dealings between licensees and the Central Bank during the transition.

Under the new regulatory landscape, the relationship between the Bank and the regulated entities, and thus, the supervisory expectations, will change, as the prudential framework evolves towards a predominantly principle-based and risk-based regulatory approach. There will be a greater emphasis on corporate governance, integrity and transparency as the foundations for industry players so as to maintain investor confidence and public trust. Under this environment, it is also envisaged that insurers, individually or collectively, will play a bigger role in developing market conduct standards, fostering fair market practices and improving financial literacy among consumers. Moving forward, as market discipline improves, and insurers and takaful operators are better positioned to implement self-regulation, further deregulation can be expected. A differentiated regulatory approach will increasingly be adopted, where companies that exhibit strong corporate governance and risk management practices will be given greater regulatory flexibility.

Commensurate with the diversity and complexity of products and services, the continuous upgrading of risk management practices, with improvements in governance standards and enhancements of information management systems will be critical. With the impending implementation of the risk-based capital framework, the responsibility for the implementation of sound risk management and market conduct governance, as well as assessment of risks and management of the financial condition of an insurer, will rest increasingly with the Board of Directors and Senior Management of the insurers.

Integral to the increased flexibility provided under the new regulatory landscape is the highest standards of integrity and ethics in the industry. Indeed, the very foundation of insurance is one that is based on a relationship of trust and integrity. Reputation and trust are indeed the valued assets of the insurance and takaful industries' business. Any lapses in market conduct will have widespread implications on the business and on the industry. Ensuring fair and equitable dealings with customers should also be a priority. In this environment where the industry originates more and more innovative and complex financial solutions, insurers and takaful operators therefore have a responsibility to ensure that:-

- consumers receive sufficient information to be able to make informed decisions;

- that they understand the key features of a policy, including any significant exclusions, before any purchase;

- that the recommended policies are suitable for their demands and needs; and

- that their claims are dealt with promptly and fairly.

The new environment of increased market discipline now places even greater emphasis on stronger corporate governance, integrity and transparency. High standards of integrity should also define the management of the institution's human and physical resources. In this respect, there can be no substitute for the commitment of an institution's leadership to uphold the highest standards of integrity in dealing with its human capital and corporate resources that are managed on behalf of shareholders and policyholders.

Achieving success in an environment of greater competition will hinge on the ability of the domestic industry to innovate and provide enhanced value propositions for consumers. This underscores the importance of capacity building by industry players in research and development, and re-engineering of business processes in search of operational excellence and enhanced customer service delivery. A strong culture of excellence is therefore vital: one that is embedded into all levels of the organisation; one that fosters and rewards innovation and service quality.

Increasingly, highly-skilled individuals will be needed to be able to deliver high value-added products and services, adopt advanced business practices, and have the necessary competencies to build consumer confidence and trust. It is, therefore, crucial for the industry to continuously invest in human intellectual capital to create the pool of talent, skills and expertise that will drive the performance of the industry. To meet this demand, specialised training organisations have been established. They include the International Centre for Leadership in Finance (ICLIF), which is now in its 3rd year of operation, and the recently-launched International Centre for Education in Islamic Finance (INCEIF). The programmes carried out by the Malaysian Insurance Institute (MII) have also been reviewed to meet the evolving demands of the financial sector.

As we move towards the final phase of the Financial Sector Master Plan and into a more competitive landscape, we require robust financial institutions that are resilient, effective and well positioned to serve the nation. In particular, to achieve a financial sector that will effectively facilitate and support sustainable economic growth and transformation. To complement the ongoing efforts to build the capacity of domestic insurers, the Bank will continue to leverage on strategic initiatives to achieve the desired financial landscape which will also be better able to contribute to the socio-economic objectives of the country, as well as to be better to withstand competitive pressures in the provision of insurance products and services.

Consolidation and fostering strategic alliances will have the potential to strengthen the position of the industry to compete more effectively as the market becomes increasingly deregulated and liberalised. In particular, in fostering strategic alliances within the industry, the foreign shareholding limit for new entries in direct insurers has been increased from 30% to 49% to harness the potential for financially strong and internationally known foreign players. This would contribute towards enhancing the development of domestic capabilities, particularly in the areas of technical expertise, innovation and improved operating processes. This will provide an additional avenue for potential foreign partners to participate more substantively in the domestic industry through a strategic equity interest in existing licensed insurers.

As part of efforts to promote good risk management practices in the financial system, the Bank will also consider introducing differentiated premium contributions to the insurance guarantee scheme fund, based on the risk profile of individual insurers. This is similar to that being adopted for the deposit insurance system in the banking sector. This will provide an incentive for insurers to strengthen their risk management practices in order to benefit from lower contributions to the insurance compensation scheme.

It is hoped that discussions at this dialogue will contribute towards providing greater clarity in the thinking on the future direction of corporate strategies as well as the regulatory responses to ensure the sound development of the insurance and takaful industry.

CALENDAR OF EVENTS
July-September 2006

7 July 2006

Three types of commemorative coins were issued in conjunction with the golden jubilee of the Federal Land Development Authority (FELDA). The coins pay tribute to FELDA in improving the standard of living and quality of life of its settlers, as well as to FELDA's founder, Malaysia's second Prime Minister, the late Tun Abdul Razak.

28 July 2006

During the fifth meeting for this year, the Bank's Monetary Policy Committee (MPC) decided to maintain the Overnight Policy Rate (OPR) at 3.50%.

2 August 2006

The Bank announced the appointment of three additional Assistant Governors, Dato' Mohd Nor bin Mashor, Puan Lillian Leong Bee Lian and Encik Gopala Krishnan Sundaram.

7 August 2006

The National SME Development Council (NSDC), of which the Bank is the Secretariat, released the inaugural SME Annual Report 2005. The report provides information on the performance of SMEs, as well as highlights the major programmes undertaken by the Government to promote the development of SMEs. The NSDC also announced the formulation of a comprehensive microfinance institutional framework to ensure adequate and continuous access to financing for micro-enterprises as well as the formation of an SME Marketing Committee to drive global marketing of SME products.

8 August 2006

At the launch of Prudential BSN Takaful Berhad in Kuala Lumpur, Governor, in her speech, spoke on the need for financial institutions with complementary strengths to form strategic alliances to develop into a world-class takaful player. The takaful industry is expected to see significant progress through the development of international best practices for the takaful industry by the Islamic Financial Services Board (IFSB).

14-15 August 2006

At the Malaysian Islamic Finance Issuers and Investors Forum 2006 in Kuala Lumpur, Governor announced the launch of the Malaysia International Islamic Financial Centre (MIFC) initiative to

position Malaysia as an international hub for Islamic finance. Backed by the country's financial and market regulators and industry players, key measures and incentives of the MIFC include :

- Approval to establish International Currency Business Units within the Malaysian Islamic banks and takaful operators, for the purpose of conducting Islamic financial services in international currencies, and to benefit from tax incentives that may be introduced;

- New conditional licences under the Islamic Banking Act 1983 to qualified foreign and Malaysian financial institutions, to conduct Islamic banking business in international currencies and enjoy tax incentives;

- New registration under the Takaful Act 1984 to qualified foreign and Malaysian insurance companies, to conduct business in international currencies and to be accorded similar tax incentives;

- Labuan offshore Islamic banks and the Islamic divisions of the offshore banks and takaful operators being allowed to open operational offices anywhere in Malaysia;

- Incentives to attract the best foreign talents and market players to the MIFC to spur innovation and the offering of attractive Islamic financial instruments; and

- The establishment of the MIFC Executive Committee to efficiently coordinate the implementation of the MIFC recommendations.

At the closing of the Forum, Deputy Governor Dato' Mohd Razif Abdul Kadir reiterated the strong commitment of the Government and regulatory agencies to spearhead the MIFC initiative, and affirmed that MIFC will be Malaysia's global brand.

22-23 August 2006

The Bank held a dialogue with the insurers and takaful operators to discuss issues, such as the transition of the insurance and takaful industries towards a risk-based regulatory and operating environment, and the development of a sustainable dual financial system for conventional insurance and takaful in Malaysia. Themed "Strategic Positioning in a Changing Environment", the dialogue also identified opportunities for complementarities and mutual synergies to be reaped between takaful operators and conventional insurers.

At the same event, Governor announced that the Bank is initiating internal organisational changes aimed at integrating the regulation of different financial institutions under its purview, along functional lines. The new structure, details of which will be issued later in the year, is intended to promote greater efficiency and competition in the financial system by :

- Minimising regulatory overlaps and duplication within the system

- Preserving regulatory neutrality in the management of similar risks between different financial service providers; and

- Ensuring more efficient use of regulatory resources.

25 August 2006

The Bank announced the establishment of the Shariah Scholarship Award and Shariah Research Grant, under the Fund for Shariah Scholars in Islamic Finance, to enhance the pool of talents, knowledge and research capacity in the field of Shariah relating to Islamic finance.

In its sixth meeting, the MPC decided to leave the OPR unchanged at 3.50%.

30 August 2006

The Bank announced that the Malaysian economy strengthened in the second quarter of 2006 with real gross domestic product expanding at 5.9%. Economic activity continued to be driven by the private sector with the services, manufacturing and agriculture sectors being the key contributors to growth.

14 September 2006

Subsequent to the announcement on MIFC in August, the Bank issued guidelines which specifiy the eligibility criteria and scope of business for the establishment of new entities in the MIFC to conduct Islamic finance business in international currencies.

15 September 2006

Bank Negara Malaysia and Banco Central de la República Argentina co-hosted the inaugural South East Asia (SEA) and Latin America and Caribbean (LAC) Central Bank Governors' Meeting. The meeting acts as a platform for central banks from both regions to exchange views on important developments affecting the economic, monetary and financial interests in Asia and the Latin American and Caribbean economies, as well as to discuss on issues of mutual interest to promote greater cooperation in the economic and financial sectors.

18 September 2006

The Bank approved the first two retakaful licenses for Munich Re and MNRB Holdings Berhad under the Takaful Act 1984, to conduct both general and family retakaful businesses in the domestic takaful industry. This development will provide the supporting institutional infrastructure for the takaful industry, as well as promote Malaysia as a centre for international currency retakaful business under the MIFC initiative.

26 September 2006

At its seventh meeting, the Bank's MPC affirmed its decision to maintain the OPR at 3.50%.

29 September 2006

The Bank announced the expansion of the operations of Agensi Kaunseling Dan Pengurusan Kredit (AKPK), at additional locations at Bank Negara Malaysia's branches in Pulau Pinang, Johor Bahru, Kuala Terengganu, Kuching and Kota Kinabalu effective 2 October 2006. The establishment of these regional offices marked the agency's continuous effort to ensure its services are available to a wider segment of the Malaysian public. AKPK provides advisory services, counselling and assistance to individuals on areas relating to credit, financial management and education as well as on debt restructuring, which are free of charge.