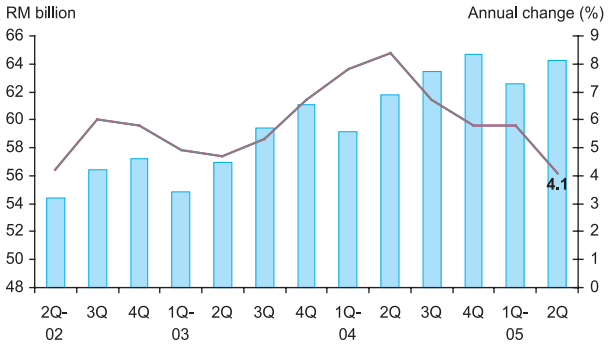
Economic and Financial Developments in the Malaysian Economy in the Second Quarter of 2005

OVERVIEW

Growth supported by private sector activity…

The Malaysian economy expanded by 4.1% in the second quarter of 2005. Private sector activity continued to be the main driver of growth.

Growth driven by private sector activities...



Source: Department of Statistics, Malaysia

Domestic demand increased by 5.6%, underpinned by strong private consumption spending and continued increase in private investment activity. Stable income and employment, amidst high export earnings and savings, as well as competitive credit market conditions, contributed to positive consumer confidence and consumer spending. Indicators of consumption spending such as credit disbursed for consumption purposes and consumer-oriented businesses as well as imports of consumption goods point to robust underlying demand.

Gross fixed capital formation rose by 6.7%, supported mainly by private investment. The resilience in private capital spending was evident in the strong growth in imports of capital goods for capital expansion and upgrading of technology and expansion of lending to the business sector. Business confidence improved as indicated by the findings of MIER's Business Conditions survey.

Despite the higher petroleum-related expenditure, improved revenue collection by the Federal Government has contained the fiscal deficit at RM2.7 billion or 2.3% of GDP in the second quarter of 2005.

On the supply side, the services sector continued to provide the main impetus to growth. Strong consumer spending, increased tourist arrivals and improved business activity led to growth of 5.4% in the services sector. In particular, the wholesale and retail trade, hotels and restaurants; transport, storage and communication; and electricity, gas and water sub-sectors, continued to experience robust growth in line with expansion in private sector activities. Value added in the manufacturing sector increased by 3.2% during the quarter. Output of electronics and electrical products improved, supported mainly by external demand for computer and computer-related products. Performance of selected resource-

based industries, namely chemical products and off-estate processing industries, continued to sustain double-digit growth to support the expansion in the export-oriented industries, which more than offset the decline in the output of selected domestic-oriented industries.

Value added in the agriculture sector grew by 3.2%, due mainly to strong expansion in palm oil production, while the mining sector contracted by 1.6% due to decline in crude oil production following the shutdown of oil fields and plants for maintenance purposes. Growth in the construction sector continued to decline, albeit at a moderate rate of 2%.

During the quarter, inflation edged up to 3% reflecting mainly cost adjustments arising from higher input prices. Demand-driven price pressures remained moderate. Meanwhile, conditions in the labour market continued to improve as the number of vacancies increased significantly in the second quarter. The strength in the labour market was also supported by strong growth in productivity.

Malaysia's external position remained strong with the trade balance recording a large surplus of RM22.9 billion. Gross exports registered a growth of 10.8%, supported by robust growth in exports of minerals (31.5%) and reinforced by expansion in exports of manufactured goods (9.2%) and agriculture commodities (5.3%). Higher receipts from crude oil was entirely due to higher prices while the increase in earnings from liquefied natural gas (LNG) was attributable to positive price and volume effects supported by stronger demand from Chinese Taipei and Japan. In the manufacturing sector, exports of electronics and electrical products (E&E) increased by 8.7% (1Q 2005: 9.9%). Stronger demand for computer-related products, particularly from the US, supported the expansion in the E&E sector. Exports of resource-based products continued to be robust, led mainly by exports of petroleum products, furniture and rubber products. Meanwhile, growth in agricultural exports was supported by increases in export receipts of sawn timber, saw logs and palm kernel oil. Export proceeds of palm oil increased, underpinned by demand from the European Union, for biodiesel production; and higher purchases by the People's Republic of China and India.

In the financial account, foreign direct investment (FDI) and portfolio investment increased during the quarter. Gross inflows of FDI increased to RM8.7 billion, channelled mainly into the oil and gas and services sectors. Malaysian corporations, particularly from the services, oil and gas and manufacturing sectors, continued to invest abroad. Meanwhile, portfolio investment recorded a higher net inflow of RM4.5 billion reflecting mainly sustained foreign interest, particularly in debt securities.

The international reserves of Bank Negara Malaysia amounted to RM285.8 billion (USD75.2 billion) as at 30 June 2005. The reserves increased to RM298.7 billion or equivalent to USD78.7 billion as at 29 July 2005. About two-thirds of the inflows in July had occurred on the day following the announcement of the change in the exchange rate regime to a managed float. The flows

normalised in the subsequent days with both inflows and outflows reflecting normal transactions. Overall, the price discovery process has been orderly. The transactions during this period were mainly for international trade, foreign direct investment and portfolio investment. International reserves amounted to RM305.2 billion or USD80.4 billion as at 15 August. During this period, there was a major drawdown of an external loan. The reserves position is sufficient to finance 9 months of retained imports and is 6 times the short-term external debt.

Monetary policy remained accommodative to support economic growth

Monetary policy during the quarter has continued to focus on supporting economic growth. The Overnight Policy Rate (OPR) remained unchanged at 2.70%. Meanwhile, the daily weighted average overnight interbank rate moved within a range of 2.67 - 2.73%, averaging at 2.70% during the quarter.

Financing of the private sector remained robust in the second quarter. Gross private sector financing grew at an annual rate of 8.7% in the second quarter, reflecting the higher loans disbursed by the banking system and the larger amount of PDS issuance. On a net basis, banking system loans and PDS outstanding increased at an annual rate of 9.3% as at end of the second quarter of 2005.

Bank lending activity remained resilient, with total loans outstanding expanding at an annual rate of 8.4% as at end of the second quarter of 2005. On a sectoral basis, the growth in loans to the household sector continued to underpin the growth in loans outstanding of the banking system. Loan disbursements for credit card spending and purchase of passenger cars supported the expansion in loan disbursements to households.

Lending to businesses remained resilient. Loans outstanding to businesses registered the third consecutive quarter of growth, increasing at an annual rate of 1.5% as at end of the second quarter of 2005. Within the business sector, lending to small and medium enterprises (SMEs) continued to drive the growth of loans to businesses, with loans outstanding to the SMEs expanding by 9% on an annual basis as at end of the second quarter of 2005. Furthermore, a higher number of SMEs accounts (21,421) had their loans approved during the quarter.

Total gross financing sourced in the PDS market was higher, amounting to RM7.8 billion in the second quarter, supported by the prevailing low yields in the bond market. The bulk of the funds raised in the second quarter were for new activity (52.8% of new issuances) and for the refinancing of existing debt (35.4%).

Monetary aggregates exhibited relatively stable growth during the quarter, with narrow money, M1, and broad money, M3, growing at annual rates of 11% and 12.8% respectively, as at end of the second quarter of 2005, reflecting the continued expansion in financing for private sector activities, as well as the expansion in net foreign assets.

On 21 July 2005, the ringgit peg to the US dollar was removed, and a managed float was introduced, whereby the value of the ringgit would be determined by economic fundamentals. Bank Negara Malaysia now monitors the exchange rate against a basket of currencies. Given that the ringgit has strengthened since the beginning of 2005, much of the undervaluation derived from the US dollar depreciation in 2004 had been reversed. At the time of the unpegging, the ringgit therefore was close to its fair value. Consequently, the exchange rate of the ringgit has not shifted significantly following the adoption of the new regime. Promoting stability of the exchange rate would continue to be a primary objective of policy.

The banking system strengthened further

The banking system showed greater resilience with key financial indicators remaining strong. The risk-weighted capital ratio (RWCR) of the banking system remained strong at 13.3% as at end of the second quarter of 2005 (1Q 2005: 13.8%). With effect from 1 April 2005, a more stringent calculation of risk-weighted assets has been adopted with the inclusion of market risk in the capital adequacy framework. Asset quality continued to improve with the lowest level of non-performing loans since the Asian crisis. The net non-performing loans (NPLs), based on the 6-month classification, declined further to 5.1% of total loans as at end-June 2005 (3-month classification: 6.9%) from 5.4% as at end-March. The improvement was due primarily to lower incidences of new loans classified as non-performing as well as continued write-offs and higher reclassification of NPLs to performing accounts. The pre-tax profits of the banking system rose by 10.9% to RM3.1 billion, attributable to higher investment income and net interest income.

The near term outlook remains favourable

Prospects for the Malaysian economy in the second half-year remain favourable. Global demand is expected to be sustained in the second half of the year based on the favourable indicators emerging recently from the US, Japan and the euro area, and further reinforced by the expected improvement in the global electronics sector in the latter part of the year. In the US, consumption spending is expected to remain strong, underpinned by the buoyant housing market. For semiconductor products, industry experts have revised upwards their growth forecast for 2005 as a whole. The favourable external environment is therefore expected to support the expansion in domestic demand. The six-month smoothed growth of Leading Index also suggests continued economic expansion. This is further supported by the MIER's Business Conditions and Consumer Sentiment Indices, which point to expansion in private sector activities in the near term.

In an environment where inflation has increased, the level of monetary accommodation will be balanced to ensure that the maximum sustainable growth is achieved in an environment of price stability. Given the uncertainties associated with both the inflation and economic outlook, particularly in relation to the impact of high oil prices, the balance of these risks will be closely monitored in setting the future course of monetary policy.

DEVELOPMENTS IN THE SECOND QUARTER OF 2005

International Economic Environment

Global economy showed improved performance

Global growth in the second quarter remained strong. Growth in the United States (US) and the People's Republic of China (PR China) was sustained while there were stronger signs of recovery in the euro area and Japan.

The **US** economy expanded by 3.4% in the second quarter. Strong consumer spending, investment and exports supported the broad-based expansion, while strong demand allowed inventories to fall for the first time since the second quarter of 2003. Most of the economic indicators such as consumer confidence, capacity utilisation and unemployment pointed towards sustained economic activities. To contain inflationary pressures amidst strong growth, the Federal Reserve continued to raise policy interest rate by 25 basis points each on 3 May, 30 June and 9 August to reach 3.5%. In **Japan**, domestic demand showed signs of recovery. Firm consumption, capital spending and a rebound in exports supported growth in the second quarter at 1.1%. In the **euro area**, GDP growth was sustained at 1.2% as Italy and Netherlands rebounded from the negative growth in the first quarter. However, high unemployment and weak domestic demand persisted. Meanwhile, the **United Kingdom** economy recorded the slowest quarterly expansion of 1.7% since 1993, with a further weakening of the manufacturing sector and a more modest expansion in the services sector.

Industrial Countries: Real GDP growth

	2004		2005			Key contributing factors for 2Q growth
	2Q	1H	1Q	2Q	1H	
	Annual change (%)					
US[1]	3.5[r]	3.9	3.8	3.4[a]	3.6[p]	Broad-based expansion supported by strength in consumer spending, investment and exports.
UK	3.7	3.6	2.1	1.7[p]	1.9[p]	Growth was supported by the services sector while industrial production continued to decline.
Euro area	2.1	1.8	1.4	1.2[p]	1.3[p]	Sustained growth as Italy and Netherlands rebounded from negative growth in 1Q.
Japan[1]	-0.6	2.3	5.4[r]	1.1[a]	3.1[p]	Recovery on track as domestic demand strengthened. Strong capital spending and private consumption supported growth.

[1] Annualised basis
[r] Revised
[a] Advanced estimate
[p] Preliminary
Source: National authorities

Global **crude oil prices** were volatile in the second quarter. Having declined to below USD50 per barrel (p/b) in May, prices of crude oil futures increased to surpass USD60 p/b towards the end of June. In addition to adverse weather conditions and geopolitical risks, fundamental factors such as continued strong global demand, especially from the US and PR China, and limited spare production and refining capacity continued to support high oil prices. Price of oil futures reached a new high of USD67.10 p/b on 12 August.

In the **Asian** region, growth improved in the second quarter, supported by several positive developments including the turnaround in the biomedical sector in Singapore, a pick-up in domestic demand in Korea, stronger consumer spending in Chinese Taipei and continued strong growth in PR China.

Regional Countries: Real GDP growth

	2004		2005			Key contributing factors for 2Q growth
	2Q	1H	1Q	2Q	1H	
	Annual change (%)					
PR China	9.6	9.7	9.4	9.6	9.5	Supported by strong investments and exports.
Indonesia	4.5	4.8	6.2	5.5	5.9	Underpinned by strong private consumption and investment.
Singapore	12.3	10.1	2.8	5.2	4.0	Attributed to an expansion in the biomedical and services sectors.
Korea	5.5	5.4	2.7	3.3[a]	3.0[a]	Supported by private consumption, investment and construction.
Chinese Taipei	7.9	7.3	2.5	3.0	2.8	Slowing exports were offset by stronger domestic spending.

[a] Advanced estimate
Source: National authorities

In most regional countries, inflationary pressures have edged upwards due to larger pass-through of high oil prices following partial or complete removals of fuel subsidies in several countries including Indonesia, Thailand and Malaysia. Thailand, Chinese Taipei, Indonesia, the Philippines and India raised interest rates during the second quarter to contain inflationary pressures. In addition, higher oil prices and weaker exports have prompted Thailand, Chinese Taipei and Korea to revise downwards their 2005 GDP growth forecast.

In the **currency markets**, the USD continued to record broad-based appreciation against the other major currencies, with the USD reaching a near nine-month high against the yen and the pound by end-June. Factors supporting the strength in the USD were yield differentials in favour of the USD and the relatively more favourable US economic indicators compared to the other major industrial countries.

On 21 July 2005, PR China announced a change in their exchange rate regime by adopting a managed float exchange rate regime with reference to a basket of currencies. The exchange rate of the USD against the RMB was adjusted to 8.11 yuan per USD (earlier: 8.28 yuan per USD). The daily trading price of the USD against the RMB in the inter-bank foreign exchange market would be allowed to float within a band of +/- 0.3% around the central parity published by the People's Bank of China (PBoC), while the trading prices of the non-USD currencies against the RMB will be allowed to move within a certain band announced by the PBoC.

Going forward, while high oil prices and rising inflationary pressures are a concern, the momentum of global demand is expected to be sustained in the second half of the year following favourable indicators from the US and more recently from the euro area and Japan. Prospects are also reinforced by an expected improvement in the global electronic sector in the latter part of the year.

Developments in the Malaysian Economy

Services sector continued to record strong growth…

The Malaysian economy expanded by 4.1% in the second quarter of 2005 (1Q 2005:

5.8%), driven mainly by private sector activity. The services sector provided the main impetus to growth, contributing to 3.1 percentage points to growth, underpinned by strong consumer spending, travel and business activity. Meanwhile, the manufacturing sector expanded at a more moderate pace, sustained by growth in selected resource-based industries as well as improvement in the electronics industry. Performance of the primary commodity sector was mixed, with continued expansion in the agriculture sector, while the mining sector recorded a decline following a contraction in crude oil production.

Quarterly GDP by Kind of Economic Activity at 1987 Prices

	2004		2005		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
Agriculture	3.7	3.8	6.0	3.2	4.5
Mining	0.8	3.3	3.4	-1.6	0.9
Manufacturing	11.9	12.2	5.7	3.2	4.4
Construction	-1.5	-0.4	-2.4	-2.0	-2.2
Services	8.1	7.3	6.2	5.4	5.8
Real GDP (Ann. Chg.)	**8.4**	**8.1**	**5.8**	**4.1**	4.9
Real GDP (Preceding Chg.)	**4.5**	**0.3**	**-3.2**	**2.7**	-0.9

Source: Department of Statistics, Malaysia

Growth in the **services sector** remained firm, expanding by 5.4% in the second quarter, supported by both intermediate and final services segments which grew by 5.1% and 5.6% respectively. The wholesale and retail trade, hotels and restaurants; transport, storage and communication; and electricity, gas and water sub-sectors, which account for about one-fourth of the entire GDP continued to expand rapidly in line with the expansion in business activities and strong consumer demand. The hospitality and transport activities were enhanced by continued increase in tourist arrivals, particularly from Korea, India and Singapore. Foreign tourist arrivals grew by 2.5% in the second quarter (1Q 2005: 4.6%). In addition, the telecommunications industry continued to perform strongly, led by the mobile segment, following the introduction of attractive packages which increased subscriber base and usage of new mobile data features. The quarter also saw the launch of the third-generation (3G) mobile phone services in the country in selected areas of the western region of Peninsular Malaysia. The 3G technology offer high value-added services such as faster transmission of information via text, digitised voice, video mail and multimedia.

Meanwhile, the finance, insurance, real estate and business services sub-sector increased by 4.7% during the quarter. This sector was supported by continued bank lending activities and further reinforced by

Performance in the Services Sector (Value Added)

		2004		2005		
	% share	2Q	1H	1Q	2Q	1H
		Annual change (%)				
Intermediate Services	**41.5**	**7.9**	**7.7**	**6.9**	**5.1**	**6.0**
Transport, storage & communication	15.2	9.1	8.5	10.4	5.9	8.1
Finance, insurance, real estate & business services	26.3	7.2	7.2	4.8	4.7	4.8
Final Services	**58.5**	**8.3**	**7.0**	**5.8**	**5.6**	**5.7**
Electricity, gas & water	7.2	8.6	8.7	5.9	6.0	5.9
Wholesale & retail trade, hotel & restaurants	24.9	10.4	7.8	7.7	7.1	7.4
Government services	12.8	6.0	5.9	3.2	3.1	3.2
Other services	13.6	6.5	5.7	4.7	4.8	4.8
Total Services	**100**	**8.1**	**7.3**	**6.2**	**5.4**	**5.8**

Source: Department of Statistics, Malaysia

Selected Quarterly Indicators in the Services Sector

	2004			2005	
	2Q	3Q	4Q	1Q	2Q
	Annual change (%)				
Hotel occupancy rate (%)	58.4	65.6	62.7	60.7	61.5
Tourist arrivals	127.4	51.5	15.4	4.6	2.5
Total passenger traffic at all airports	44.6	15.2	11.2	6.6	5.5
Total consumption credit outstanding	13.3	14.7	16.4	17.4	17.8
Loan outstanding to the wholesale & retail trade, restaurants & hotels	6.7	9.5	11.0	12.7	12.6
Imports of consumption goods	28.0	38.8	16.4	10.7	4.1
Total sales of new motor vehicles	24.5	22.3	29.8	21.8	8.1
Cellular phone penetration rate (%)	48.5	50.8	56.5	60.9	63.3
SMS traffic	45.2	53.0	77.8	70.6	91.0
Cargo handled (All airports)	11.3	13.7	10.2	5.3	5.3
Container cargo handled (Port Klang and PTP)	17.8	8.8	3.6	4.7	2.1
Cargo revenue (Railway)	-0.4	19.9	12.2	7.7	4.2

Source: Various sources

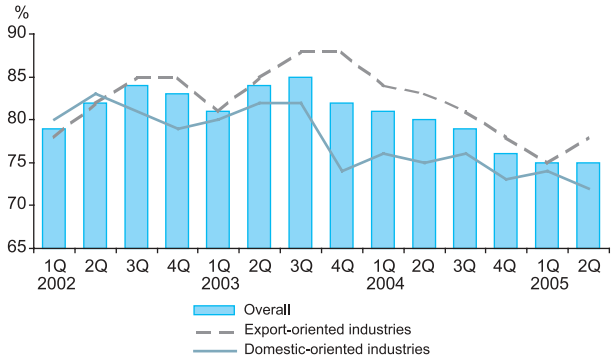
strong insurance activities, particularly the life insurance segment. Growth in the utilities sub-sector continued to remain firm at 6% (1Q 2005: 5.9%) reflecting demand for electricity from all categories of users, namely, industrial, commercial and households.

Moderate expansion in the manufacturing sector ...

Value added in the **manufacturing sector** expanded by 3.2% in the second quarter of 2005 (1Q 2005: 5.7%). Output of the **export-oriented industries** grew by 4.1% (1Q 2005: 5.4%) supported by continued expansion of selected resource-based industries, and an improvement in the electrical and electronics products industry (1.1%; 1Q 2005: -1.2%). During the quarter, resource-based industries, such as chemical products and off-estate processing industries sustained double-digit growth rates of 10.6% and 18.9% respectively (1Q 2005: 16% and 24.6% respectively). The expansion in the chemical products industry was led by higher production of plastic products in response to the strong demand from the regional countries. Off-estate processing benefited from the strong output of crude palm oil production during the quarter. Meanwhile, output of rubber products declined marginally by 0.1% (1Q 2005: 10.9%) due partly to the lower output of tyres arising from difficulty in sourcing components.

The **domestic-oriented industries** recorded a decline in production (-1.3%; 1Q 2005: 6.4%). Strong growth in the transport equipment and beverages industries (9.7% and 21.1% respectively) was offset by contraction in the output of fabricated metal and construction-related industries (-12.5% and -5.2% respectively). Non-metallic mineral products, basic metals and fabricated metal products were affected by the subdued performance in the

Capacity Utilisation in the Manufacturing Sector



Performance in the Manufacturing Sector

	2004		2005		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
Value Added (Constant Price)	**11.9**	**12.2**	**5.7**	**3.2**	**4.4**
Overall Production	**15.7**	**16.1**	**5.6**	**2.9**	**4.2**
Export-oriented industries	**18.2**	**18.7**	**5.4**	**4.1**	**4.7**
Of which:					
Electronics and electrical products	23.9	24.5	-1.2	1.1	0.0
Electronics	33.0	33.6	-0.1	3.2	1.6
Electrical	-7.7	-7.3	-7.1	-9.2	-8.2
Textiles & wearing apparel	-7.8	-9.3	-4.4	-5.6	-5.0
Chemicals and chemical products	18.2	17.6	16.0	10.6	13.3
Off-estate processing	-5.9	-1.8	24.6	18.9	21.6
Rubber products	21.2	22.6	10.9	-0.1	5.3
Wood and wood products[1]	20.9	17.5	-3.4	-6.5	-5.0
Domestic-oriented industries	**7.5**	**7.5**	**6.4**	**-1.3**	**2.5**
Of which:					
Transport equipment	10.0	5.3	13.5	9.7	11.5
Fabricated metal products	23.9	29.1	15.9	-12.5	0.8
Iron & steel and non-ferrous metal	9.0	7.6	-3.6	-6.3	-5.0
Non-metallic mineral products	-8.6	-5.1	-3.6	-4.1	-3.8
Petroleum products	-5.1	-3.5	10.4	5.8	8.1
Food	7.6	7.5	2.3	6.2	4.2
Total Manufactured Exports	**20.7**	**19.1**	**12.0**	**9.2**	**10.6**
Of which:					
Electronics and electrical products	18.1	16.7	9.9	8.7	9.3
Semiconductors	7.1	5.9	6.4	-3.3	1.3
Electronics equipment and parts	22.9	21.1	9.7	21.6	15.9
Electrical appliance	28.7	27.6	15.3	6.3	10.5
Wood and wood products	32.3	30.4	16.8	4.5	10.4
Furniture & parts	15.3	15.2	10.3	11.9	11.1
Rubber products	21.6	20.8	11.9	9.4	10.6
Optical & scientific equipment	33.5	22.8	22.9	-4.3	7.5
Chemical and chemical products	28.1	27.1	20.7	3.1	11.4
Petroleum products	26.0	22.7	18.0	44.6	30.3

[1] Output of furniture and parts are not captured in the wood production data.

Source: Department of Statistics, Malaysia

construction sector. Meanwhile, the transport equipment industry continued to remain robust, benefiting from the high level of passenger car sales driven by the low interest rates and the launch of new car models during the year.

The **overall capacity utilisation** of the manufacturing sector remained at 75% in the second quarter of 2005 (1Q 2005: 75%). The capacity utilisation rate of the export-oriented industries increased to 78% (1Q 2005: 75%), while the domestic-oriented industries operated at 72% (1Q 2005: 74%).

Mixed performance in the commodity sector ...

The **agriculture sector** recorded a growth of 3.2% in the second quarter of 2005

Performance in the Agriculture Sector

	2004		2005		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
Value Added (at 1987 prices)	**3.7**	**3.8**	**6.0**	**3.2**	**4.5**
Production[1]					
Of which:					
Crude palm oil	-5.8	-2.3	27.5	14.5	20.3
Crude palm kernel oil	-10.9	-4.4	27.2	25.1	26.1
Rubber	29.8	23.9	-9.2	-6.7	-8.1
Saw logs	4.4	-3.8	-2.2	-15.8	-10.2
Cocoa	-8.5	-22.5	-11.9	-29.9	-21.2
Exports (RM million)	**12.0**	**12.9**	**6.2**	**5.3**	**5.7**
Of which:					
Palm oil					
('000 tonnes)	-12.1	-4.4	13.9	29.0	21.6
(RM/tonne)	16.9	11.9	-15.7	-21.1	-18.6
(RM million)	2.8	7.0	-4.0	1.8	-1.0
Palm kernel oil					
('000 tonnes)	26.1	30.2	14.5	8.9	11.5
(RM/tonne)	60.7	45.0	8.3	-2.1	2.3
(RM million)	102.6	88.9	24.1	6.6	14.1
Rubber					
('000 tonnes)	12.0	17.6	-0.8	5.3	2.2
(Sen/kilogramme)	36.0	36.2	-2.2	-3.2	-2.6
(RM million)	52.3	60.1	-2.9	2.0	-0.5
Sawn timber					
('000 cu.metres)	15.6	11.0	47.8	10.4	27.3
(RM/cu.metre)	-17.8	-15.3	-10.3	17.5	3.0
(RM million)	-4.9	-6.0	32.6	29.7	31.1
Saw logs					
('000 cu.metres)	-11.5	-12.4	42.2	15.4	26.9
(RM/cu.metre)	20.2	11.7	4.4	-5.1	-1.4
(RM million)	6.4	-2.1	48.4	9.5	25.1
Cocoa beans					
('000 tonnes)	-8.3	-42.3	183.4	-15.8	25.8
(RM/tonne)	-12.9	-14.0	0.7	-6.9	-6.1
(RM million)	-20.1	-50.4	185.3	-21.6	18.1

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

Source: Malaysian Palm Oil Board (MPOB)
Malaysian Rubber Board (MRB)
Forestry Department (Peninsular Malaysia, Sabah and Sarawak)
Malaysian Cocoa Board (MCB)
Department of Statistics, Malaysia

(1Q 2005: 6%). Production of crude palm oil continued to grow at a strong pace of 14.5% (1Q 2005: 27.5%) to 3.75 million tonnes, the highest quarterly level recorded. The strong performance was supported by growth in productivity, both in terms of fresh fruit bunches (FFB), which rose to 4.68 tonnes per hectare (1Q 2005: 4.35 tonnes per hectare), and oil extraction rate (OER), which increased to 20.04% (2Q 2004: 19.99%). The stronger yields were mainly in Sabah (produces approximately 30% of Malaysia's palm oil), due to a higher percentage of trees that are in their peak production period. Thus, the monthly average production of crude palm oil was significantly higher at 1.25 million tonnes (2Q 2004: 1.09 million tonnes). In contrast, rubber production declined for the second consecutive quarter by 6.7% as dry weather spells led to lower latex output. The dry weather has also caused irrigation problems in paddy-growing regions, thus causing a significant reduction in paddy output during the quarter.

Meanwhile, the **mining sector** was affected by lower production of crude oil (including condensates), which declined by 9.2% to 670,523 barrels per day. The decline was a result of the shutdowns of several oil fields and plants for maintenance purposes. Crude oil prices continued to be volatile during the quarter, underlining the fine balance between supply and demand and the tight spare capacity in the major oil producing countries. This was further aggravated by refinery constraints in major consuming countries which led to the increase in the price of Tapis Blend. Tapis Blend, which commands a premium due to its superior qualities,

Performance in the Mining Sector

	2004		2005		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
Value Added (at 1987 prices)	**0.8**	**3.3**	**3.4**	**-1.6**	**0.9**
Production					
Of which:					
Crude oil and condensates ('000 barrels)	-0.2	3.8	-5.2	-9.2	-7.2
Natural gas (net) (million standard cubic feet)	4.0	3.1	19.8	12.1	16.0
Exports (RM million)	**43.9**	**28.3**	**34.8**	**31.5**	**33.1**
Of which:					
Crude oil & condensates					
('000 tonnes)	4.4	4.3	-1.1	-5.3	-3.2
(USD/barrel)	33.6	17.7	36.0	43.4	39.6
(RM million)	39.5	22.7	34.5	35.7	35.1
Liquefied natural gas					
('000 tonnes)	34.1	25.5	17.6	2.5	10.2
(RM/tonne)	1.5	-0.5	12.8	14.0	13.3
(RM million)	36.0	24.8	32.7	16.8	24.9

Source: PETRONAS
Department of Statistics, Malaysia

breached the USD60 mark in early April, before stabilizing in the range of USD55 - 58 per barrel during the rest of the quarter.

Meanwhile, natural gas production continued to increase at a double-digit rate of 12.1% to 5,657 million standard cubic feet per day (1Q 2005: 19.8%). The higher production was driven mainly by higher capacity utilisation of the Malaysia Liquefied Natural Gas (MLNG) plants in Sarawak and Gas Processing Plants (GPPs) in Peninsular Malaysia, induced by higher demand from LNG importing countries (Japan and Chinese Taipei).

Contraction in construction activity …

The **construction sector** contracted by 2% (1Q 2005: -2.4%) due mainly to lower activity in the civil engineering sub-sector.

Activity in the residential and non-residential segments continued to expand, supported by demand for houses and office space. In particular, the renewed interest in office space was reflected by the increase in occupancy rates and incoming supply in the Klang Valley. Amidst the consolidation in the civil engineering sub-sector, Malaysian construction companies continued to bid for overseas projects to diversify their earnings base. Their initiatives have showed positive results with Malaysian contractors successfully securing several infrastructure projects in India and the Middle East.

Construction Indicators

	2004		2005		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
New sales and advertising permits	0.7	18.9	2.3	10.1	6.2
Housing approvals	-14.9	8.5	11.2	-26.9	-7.8
Production of construction-related materials	-0.8	0.7	-3.6	-5.2	-4.4
Loans approved for construction	31.2	-6.4	47.6	-14.5	8.7
Imports of construction materials & mineral products	56.8	37.1	6.1	-7.3[1]	0.1[2]

[1] *Apr.-May 2005*
[2] *Jan.-May 2005*

Source: Ministry of Housing and Local Government and Department of Statistics, Malaysia

Private sector spending remains strong

Domestic demand increased by 5.6% in the second quarter of 2005. The private sector continued to provide the main impetus to growth, while there continued to be on-going progress in the Government fiscal consolidation programme.

Private consumption continued to increase strongly in the second quarter, expanding by 7.4% (1Q 2005: 10.1%).

GDP by Expenditure Components (at Constant 1987 prices)

	2004		2005		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
Aggregate Domestic Demand (excluding stocks)	8.8	8.2	5.9	5.6	5.8
Consumption	11.3	10.4	7.6	5.1	6.3
Private sector	*11.9*	*10.4*	*10.1*	*7.4*	*8.7*
Public sector	*9.4*	*10.5*	*-2.3*	*-2.4*	*-2.4*
Gross Fixed Capital Formation	3.5	3.5	2.0	6.7	4.5
Exports of Goods and Services	20.4	18.4	9.5	7.9	8.6
Imports of Goods and Services	25.8	23.5	7.6	6.9	7.3
GDP	**8.4**	**8.1**	**5.8**	**4.1**	**4.9**

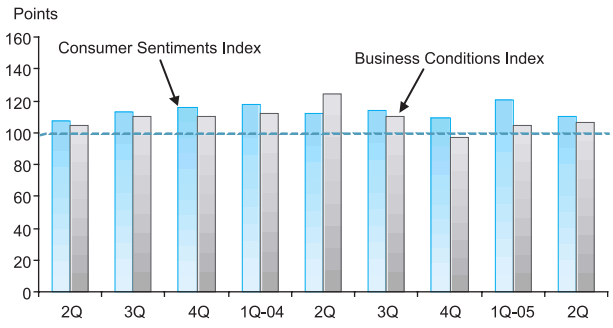
Source: Department of Statistics, Malaysia

Stable income and employment market conditions, amidst high savings and competitive credit market conditions led to sustained strong consumer spending. The findings of the consumer sentiments survey of the Malaysian Institute of Economic Research (MIER) indicated that consumers remained optimistic although there was some concern on rising prices. The MIER's Consumer Sentiment Index (CSI) remained above the 100-point threshold at 109.8 points (1Q 2005: 120.9 points), signifying continued expansion in household consumption. Other major consumption indicators such as loans approved and disbursed for consumption credit and consumer-oriented businesses, credit card transactions and imports of consumption goods, also supported the positive trend in private consumption.

Meanwhile, **public consumption** declined during the quarter (-2.4%; 1Q 2005: -2.3%) mainly on account of lower expenditure on defence.

Gross fixed capital formation strengthened to 6.7% in the second quarter (1Q 2005: 2%) even as the Federal Government's investment activities continued to decline. Investment indicators suggest that private capital spending increased firmly during the quarter. MIER's Business Conditions Index improved to 106 points (1Q 2005: 104.1 points). Other major indicators, especially imports of capital goods, sales of commercial vehicles and loans disbursed to businesses, also reflected stronger investment activities in the second quarter.

Consumer and business confidence remain optimistic

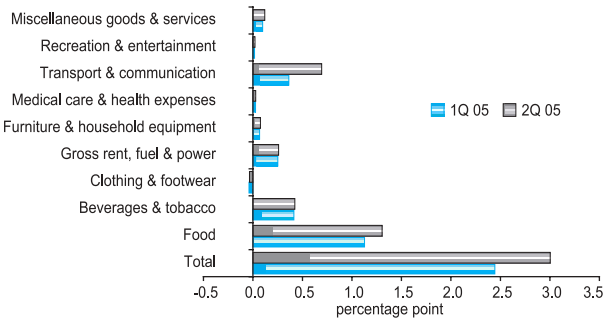


Cost factors led to higher inflation

The annual rate of inflation, as measured by the **Consumer Price Index** (CPI), increased to 3% (1Q 2005: 2.4%). The increase was driven mainly by the higher prices of food and transportation. The increase in prices of food was due to the higher prices of both food at home and food taken away from home. Meanwhile, the increase in prices of transportation was due mainly to the increase in bus and taxi fares as well as higher retail prices of petroleum products, which became effective in May.

The **Producer Price Index** (PPI) increased at an annual growth of 6.2% (1Q 2005: 5.1%), driven by higher prices of crude oil, which more than offset the decline in the prices of rubber and crude palm oil. Excluding commodities, the PPI, however, was stable at 2.2% in the second quarter (1Q 2005: 2.5%).

Contribution to Inflation



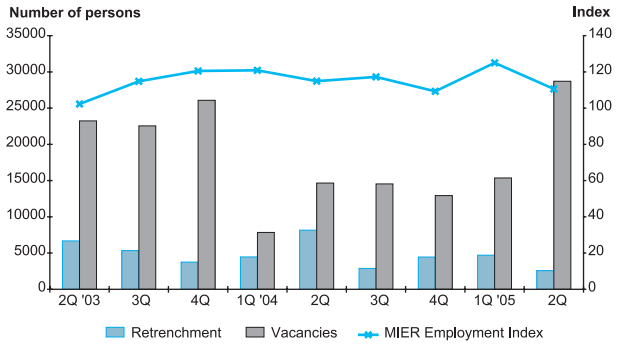
Labour market conditions continued to improve

Labour market conditions in the second quarter continued to improve. Vacancies reported to the authorities increased (28,715 positions; 1Q 2005: 15,369 positions), while retrenchments were lower (2,570 persons; 1Q 2005: 4,709 persons). The number of unplaced jobseekers rose to 82,708 persons as at end of June 2005 (33,740 persons as at end March 2005). However, while a record high, the data is not comparable with past series. With effect from May 2005, the registration period during which jobseekers

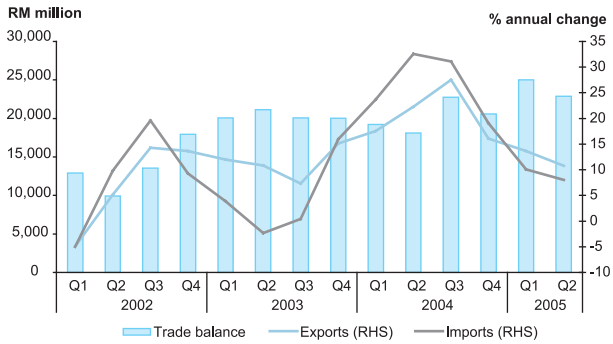
are deemed to be actively seeking jobs was lengthened to six months (three months previously).

Growth in labour productivity during the quarter, as measured by real sales value of products per employee in the manufacturing sector, rose by 10.2%. Real wages per employee declined by 0.4%.

Labour Market Conditions Improved



Trade balance



Exports and imports continued to expand

The **trade account** recorded a large surplus of RM22.9 billion (1Q 2005: RM25 billion). Gross exports and imports continued to expand, albeit at more moderate rates of 10.8% and 8% respectively.

Gross exports grew by 10.8% in the second quarter of 2005 (1Q 2005: 13.7%) supported mainly by robust growth in mineral exports (31.5%) and reinforced by expansion in manufactured goods (9.2%) and agriculture commodities (5.3%). Exports of **manufactured goods** expanded by 9.2% (1Q 2005: 12%), reflecting an increase of 8.7% in electronics and electrical (E&E) products (1Q 2005: 9.9%). While external demand for semiconductors remained subdued, exports of personal computers and laptops had improved. Of significance, exports of resource-based products continued to be robust, led mainly by exports of petroleum, furniture and rubber products. Despite the increase in cost of raw materials, exports of rubber products continued to expand by 9.4% (1Q 2005: 11.9%), reflecting the strong global demand for high quality natural rubber gloves. Overall, the increase in exports of manufactured goods during the quarter was due to increases in both unit value (3%) and volume (6.1%).

Mineral exports continued with its strong trend seen in recent quarters, expanding by 31.5% during the quarter. Malaysia being a net exporter of crude petroleum benefited from the upward trend in crude oil prices, as Malaysian crude oil is of the premium light and sweet grade, and hence earned a higher price compared with the heavy and sour crude grade. In line with these developments, Malaysian crude oil export prices strengthened significantly during the

quarter, rising by 43.4% to average USD54.28 per barrel. However, export volume fell during the quarter (-5.3%), in line with the contraction in crude oil production during the quarter. Exports of liquefied natural gas (LNG) rose by 16.8%, supported by both higher prices (14%) and volume (2.5%). LNG prices hit a record monthly high of RM918 per tonne in June 2005. Higher demand for LNG was most evident from Malaysia's major LNG buyers, namely Chinese Taipei (46.6%) and Japan (5.6%).

Trade Account

	2004		2005		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
Gross Exports	**22.3**	**20.0**	**13.7**	**10.8**	**12.2**
Manufacturing	*20.7*	*19.1*	*12.0*	*9.2*	*10.6*
Agriculture	*12.0*	*12.9*	*6.2*	*5.3*	*5.7*
Minerals	*43.9*	*28.3*	*34.8*	*31.5*	*33.1*
Gross Imports	**32.6**	**28.2**	**10.1**	**8.0**	**9.0**
Capital goods	*37.0*	*34.0*	*0.7*	*17.0*	*9.2*
Intermediate goods	*29.9*	*25.6*	*10.6*	*5.8*	*8.0*
Consumption goods	*28.0*	*21.5*	*10.7*	*4.1*	*7.2*
Trade balance (RM bil)	**18.1**	**37.3**	**25.0**	**22.9**	**47.9**

Source: Department of Statistics, Malaysia

Agriculture exports rose by 5.3% (1Q 2005: 6.2%), supported by increases in export receipts from sawn timber, saw logs and palm kernel oil. Meanwhile, proceeds from palm oil, the largest export item, increased, albeit marginally by 1.8% during the quarter due entirely to lower prices (declined by 21.1% to RM1,449 per tonne), from the exceptionally high levels seen in the corresponding period of 2004 (RM1,835 per tonne). However, shipments remained robust, growing by 29%, in response to strong purchases by the European Union (64.8%), for the purpose of producing biodiesel. In addition, palm oil exports to the People's Republic of China increased by 32.1% reflecting the highest monthly level in May (357,200 tonnes), while exports to India rebounded strongly by 49.5%, after six straight quarters of decline, due to lower- than- expected harvests of domestic rapeseed crop.

Malaysia's trade with the regional countries (excluding Japan) grew by 11.8%, with the export share sustained at 44.3%. The growth emanated mainly from exports

Malaysia: Direction of exports

	2004		2005			2004		2005			2004		2005		
	2Q	1H	1Q	2Q	1H	2Q	1H	1Q	2Q	1H	2Q	1H	1Q	2Q	1H
	RM billion					Share of total exports (%)					Annual change (%)				
United States	**22.8**	**42.0**	**21.6**	**27.0**	**48.6**	**19.3**	**18.6**	**17.6**	**20.6**	**19.2**	**15.6**	**13.9**	**12.2**	**18.4**	**15.6**
European Union (EU) [1]	**14.6**	**28.5**	**14.6**	**15.0**	**29.6**	**12.4**	**12.6**	**11.9**	**11.5**	**11.7**	**18.4**	**18.2**	**5.3**	**2.6**	**4.0**
Selected ASEAN countries[2]	**28.9**	**55.8**	**32.6**	**33.8**	**66.3**	**24.5**	**24.7**	**26.6**	**25.8**	**26.2**	**21.5**	**19.5**	**20.9**	**16.9**	**18.8**
North East Asia	**23.1**	**45.0**	**23.5**	**24.1**	**47.6**	**19.6**	**19.9**	**19.2**	**18.4**	**18.8**	**26.9**	**25.2**	**7.3**	**4.2**	**5.7**
People's Republic of China	*8.1*	*15.3*	*8.0*	*8.3*	*16.2*	*6.8*	*6.8*	*6.5*	*6.3*	*6.4*	*30.2*	*33.0*	*10.8*	*2.4*	*6.4*
Hong Kong China	*7.5*	*14.0*	*7.1*	*7.9*	*15.0*	*6.4*	*6.2*	*5.8*	*6.1*	*5.9*	*25.3*	*17.0*	*9.7*	*5.2*	*7.3*
Chinese Taipei	*3.8*	*7.4*	*3.1*	*3.8*	*6.8*	*3.3*	*3.3*	*2.5*	*2.9*	*2.7*	*11.2*	*8.9*	*-14.4*	*-1.4*	*-7.7*
Korea	*3.7*	*8.4*	*5.4*	*4.1*	*9.5*	*3.1*	*3.7*	*4.4*	*3.2*	*3.8*	*43.4*	*45.8*	*14.9*	*11.8*	*13.6*
India	**2.7**	**5.4**	**3.7**	**3.3**	**6.9**	**2.3**	**2.4**	**3.0**	**2.5**	**2.7**	**10.5**	**15.9**	**37.0**	**19.0**	**27.9**
Total exports	**118.0**	**225.8**	**122.6**	**130.7**	**253.3**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**22.3**	**20.0**	**13.7**	**10.8**	**12.2**

[1] Includes the 10 new member states

[2] Singapore, Thailand, Indonesia, Philippines, Brunei Darussalam and Viet Nam

Source: Department of Statistics, Malaysia

to Singapore, Thailand, Indonesia, Hong Kong China and Korea. Major exports that recorded increases were E&E products, metal products, refined petroleum products and rubber products. Increased sourcing of components from regional countries caused growth in imports from these countries to outpace export growth. Hence, the trade balance with regional countries narrowed to RM6.1 billion (1Q 2005: RM8.6 billion). The key imports from the region included machinery, appliances and parts, chemicals, manufactures of metal and plastics.

Exports to the United States (US) in the second quarter grew strongly reflecting mainly higher demand for E&E products, particularly computers and laptops. Export growth to Australia strengthened by 17.1% (1Q 2005: 16.6%) on account of resource-based products.

The increase in **gross imports** of 8% reflected expansion in private investment activity and demand for inputs for the production of exports of manufactured goods as well as domestic consumption. Imports of **intermediate goods**, which were inputs used for manufactured goods, expanded by 5.8%. The growth in intermediate imports was supported mainly by higher imports of primary materials used by the food and beverages industry, electronics and industrial supplies, particularly metal and chemical products. Consistent with the growth in the motor assembly industry, imports of transport equipment as well as parts and accessories of motor vehicles continued to expand. Higher oil prices also led to growth in imports of fuel and lubricants.

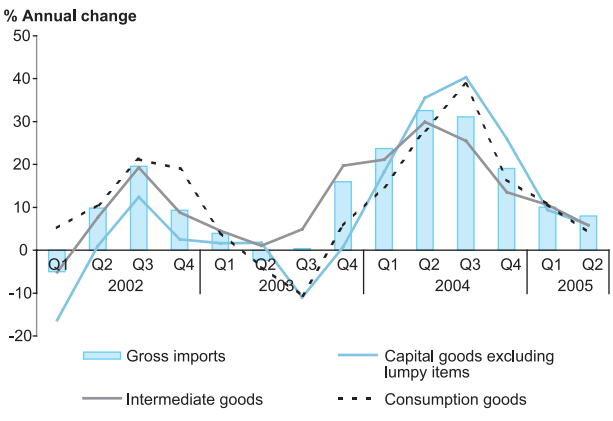
Imports of **capital goods** expanded by 17%. Capital imports excluding lumpy

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

	2004		2005		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
CAPITAL GOODS	**37.0**	**34.0**	**0.7**	**17.0**	**9.2**
Capital goods (except transport equipment)	34.4	27.4	7.3	9.5	8.5
Transport equipment	106.4	174.1	-43.0	147.2	15.8
INTERMEDIATE GOODS	**29.9**	**25.6**	**10.6**	**5.8**	**8.0**
Food and beverages, mainly for industry	111.1	66.2	-7.9	-12.5	-10.4
Industrial supplies, n.e.s.	49.1	37.4	16.0	7.5	11.3
Fuel and lubricants	23.1	11.3	95.7	41.6	63.9
Parts and accessories of capital goods (except transport equipment)	18.1	19.4	0.1	-0.7	-0.3
Parts and accessories of transport equipment	47.8	31.8	40.9	56.4	49.0
CONSUMPTION GOODS	**28.0**	**21.5**	**10.7**	**4.1**	**7.2**
Food and beverages, mainly for household consumption	37.8	28.2	9.5	2.7	6.0
Transport equipment, non-industrial	16.1	-10.8	-16.2	-20.4	-18.5
Consumer goods, n.e.s.	22.9	18.5	12.2	5.7	8.7
Durables	*19.1*	*15.5*	*11.3*	*20.3*	*16.0*
Semi-durables	*24.1*	*20.2*	*3.4*	*-3.9*	*-0.6*
Non-durables	*23.9*	*18.7*	*19.2*	*5.9*	*11.9*
DUAL USE GOODS	**34.8**	**31.4**	**17.0**	**38.3**	**27.9**
OTHERS	**6.6**	**7.0**	**-6.0**	**1.5**	**-2.2**
RETAINED IMPORTS	**30.3**	**26.2**	**9.0**	**7.9**	**8.4**
RE-EXPORTS	**117.3**	**103.6**	**35.3**	**9.3**	**21.2**
GROSS IMPORTS	**32.6**	**28.2**	**10.1**	**8.0**	**9.0**

Source: Department of Statistics, Malaysia

Import growth

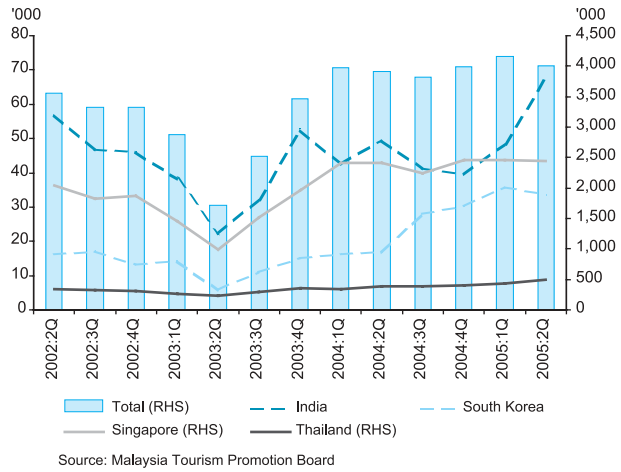


items grew by 5.9%. The increase in imports for capacity expansion and upgrading of technology occurred in the services sector, as evidenced by the strong growth in imports of office equipment and generators, turbines and electric motors. Imports of office equipment strengthened as corporations in the services industry improved their service delivery by upgrading infrastructure in information technology. Strong external demand for commodity exports and fleet expansion to service new markets also led to higher imports of aircraft and ships. Growth in imports of **consumption goods** of 4.1% reflected mainly growth in imports of processed food and beverages for household consumption and consumer goods.

Continued growth in tourist arrivals

Tourist arrivals increased by 2.5% to 4 million visitors in the second quarter of 2005. The increase in arrivals was attributed to visitors from Singapore, Thailand and Indonesia which together accounted for 78.6% of tourist arrivals. Visitors from South Korea, India, Australia and New Zealand also increased, supported by attractive promotional packages and greater connectivity with more flights and gateway points.

Quarterly Tourist Arrivals



Source: Malaysia Tourism Promotion Board

Higher inflows of FDI and portfolio investment

In the financial account, gross inflows of **foreign direct investment (FDI)**, based on cash basis, increased to RM8.7 billion in the second quarter of 2005 (1Q 2005: RM5 billion), reflecting larger inflows of inter-company loans and equity capital. More than a third of the FDI inflows were channelled into the oil and gas sector, particularly in the form of loans extended by a foreign company to its subsidiary in Malaysia. Meanwhile, FDI inflows into the services sector were channelled mainly into the financing, insurance and business services, as well as restaurants, hotels, wholesale and retail trade sub-sectors. In the manufacturing sector, FDI inflows were received mainly by companies in the petroleum products, photographic and optical products as well as electrical and electronics sub-sectors. After adjustments for outflows due mainly to larger repayment of loans to related companies abroad, net FDI recorded an inflow of RM3 billion.

Overseas investment recorded a gross outflow of RM21 billion (1Q 2005: -RM30 billion), reflecting mainly short-term loan extension 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 arising from repayment of short-term inter-company loans during the quarter. Overseas investment by companies in the manufacturing, services and oil and gas sectors was sustained during the quarter. After adjusting for inflows mainly from repayment of inter-company loans from abroad, overseas investment recorded a net outflow of RM2.6 billion (1Q 2005: -RM3.2 billion).

Meanwhile, **portfolio investment** recorded a higher net inflow of RM4.5 billion (1Q 2005: RM2.8 billion). The increase during the quarter reflected mainly sustained foreign interest, particularly in the debt securities.

External debt declined

Malaysia's total external debt declined further to RM196.2 billion or USD51.6 billion as at end-June 2005 (1Q 2005: RM198 billion or USD52.1 billion), equivalent to 44.2% of GNP. The lower **medium and long-term external debt** at RM152.7 billion (1Q 2005: RM157.1 billion),

External Debt Outstanding

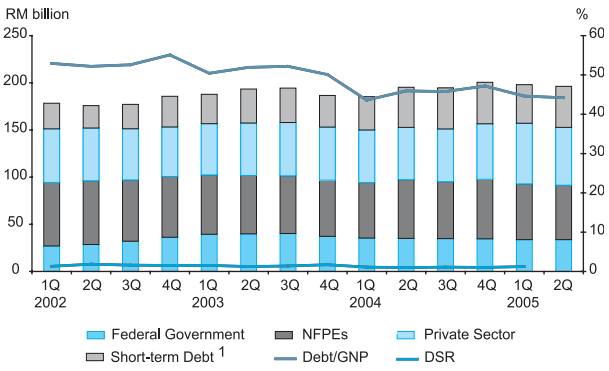
	2004	2005	
	2Q	1Q	2Q[p]
	RM billion		
Medium- and Long-term debt	152.7	157.1	152.7
Public sector	97.3	92.9	91.4
Private sector	55.4	64.2	61.3
Short-term debt[1]	42.6	40.9	43.5
Total external debt	195.3	198.0	196.2
- USD billion equivalent	51.4	52.1	51.6

[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

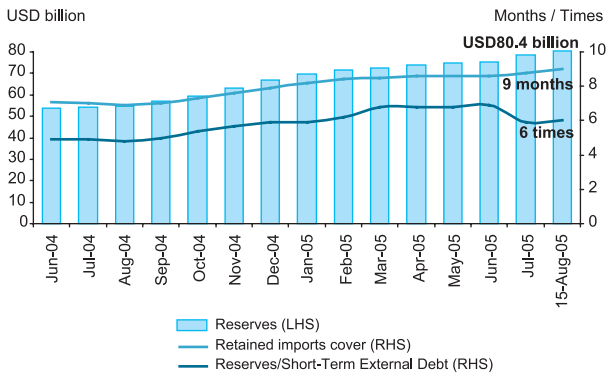
was attributable to net repayment of external loans by both the private sector and the non-financial public enterprises (NFPEs). Net repayment of the private sector amounted to RM2.7 billion during the quarter, mainly by companies in the agriculture, utilities and manufacturing sectors. The NFPEs registered a smaller net repayment of RM0.9 billion. Meanwhile, the Federal Government recorded a small net drawdown of external loan (RM0.3 billion) during the quarter due mainly to scheduled drawdown of loans committed earlier.

The total **short-term external debt** increased to RM43.5 billion or USD11.4 billion (1Q 2005: RM40.9 billion), reflecting increases in the short-term borrowings of both the banking and non-bank private sectors. The bulk of the increase of the non-bank private sector emanated from the revolving credit facilities. As at end-June, the short-term external debt remained low, accounting for only 22.2% of total external debt and is about 15.2% of the net international reserves.

International reserves increased amidst orderly transition to a managed float

The international reserves of Bank Negara Malaysia amounted to RM285.8 billion (USD75.2 billion) as at 30 June 2005. The reserves increased to RM298.7 billion or equivalent to USD78.7 billion as at 29 July 2005. About two-thirds of the inflows in July had occurred on the day following the announcement of the change in the exchange rate regime to a managed float. The flows were normalised in the subsequent days and the price discovery process has been orderly. The transactions in July were mainly for international trade, FDI and portfolio investment. It also reflected the transactions for payments for imports of goods and services, repatriation of dividends and overseas investment by Malaysian companies. International reserves amounted to RM305.2 billion or equivalent to USD80.4 billion as at 15 August 2005. During this period, there was a major drawdown of an external loan. The reserves position is adequate to finance 9 months of retained imports and is 6 times the short-term external debt.

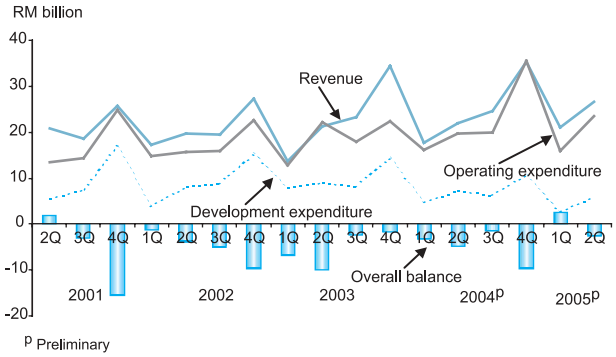
Net International Reserves (as at end-period)



Lower fiscal deficit

Despite the higher petroleum-related expenditure, improved revenue collection by the Federal Government has contained the fiscal deficit at a lower level of RM2.7 billion or 2.3% of GDP in the second quarter of 2005

Federal Government Finance



p Preliminary

Federal Government Finance p

	2004		2005		
	2Q	1H	1Q	2Q	1H
	RM billion				
Revenue	21.8	39.6	21.1	26.6	47.7
% growth	*2.9*	*13.3*	*19.2*	*21.9*	*20.7*
Operating expenditure	19.7	35.9	15.9	23.4	39.3
% growth	*-11.4*	*2.5*	*-1.5*	*18.7*	*9.6*
Current account	**2.1**	**3.7**	**5.2**	**3.2**	**8.4**
% of GDP	***1.9***	***1.7***	***4.5***	***2.7***	***3.6***
Gross development expenditure	7.3	12.1	2.8	5.9	8.7
% growth	*-19.9*	*-28.3*	*-42.9*	*-18.3*	*-28.1*
Loan recoveries	0.2	0.3	0.2	0.1	0.2
Overall balance	**-4.9**	**-8.1**	**2.6**	**-2.7**	**-0.1**
% of GDP	***-4.5***	***-3.8***	***2.3***	***-2.3***	***...***
Memo item:					
Total gross expenditure	**27.0**	**48.0**	**18.7**	**29.3**	**48.0**
% growth	*-13.8*	*-7.5*	*-11.1*	*8.7*	*0.1*
Total Federal Government debt (as at end-period)	197.8	197.8	223.1	222.6	222.6
% of GDP	*44.0*	*44.0*	*47.4*	*47.3*	*47.3*
Domestic debt	160.8	160.8	189.3	188.9	188.9
% of GDP	*35.8*	*35.8*	*40.2*	*40.2*	*40.2*
External debt	37.0	37.0	33.8	33.7	33.7
% of GDP	*8.2*	*8.2*	*7.2*	*7.2*	*7.2*

p Preliminary

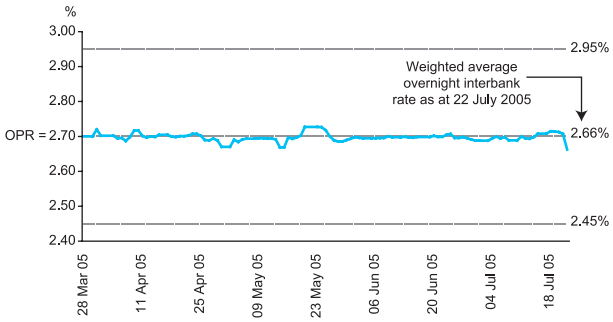
(2Q 2004: -4.5% of GDP). Revenue receipts strengthened, reflecting mainly the higher collection from petroleum income tax and most major categories of indirect taxes; especially excise duty given the strong growth in car sales. Total expenditure rose at an annual rate of 8.7%, due to higher operating expenditure as increases in oil prices resulted in higher payments of subsidies. On 5 May, the Government raised the prices of retail petroleum products for the second time during the year to help mitigate some of the impact of the high oil prices. Given the ample liquidity condition in the domestic banking system, the Government's financing requirements were met mainly from domestic sources. As at end-2Q 2005, total outstanding debt of the Federal Government amounted to RM222.6 billion or 47.3% of GDP. The external debt of the Federal Government continues to remain low, at 17.2% of the nation's outstanding external debt or 7.2% of GDP.

MONETARY AND FINANCIAL DEVELOPMENTS

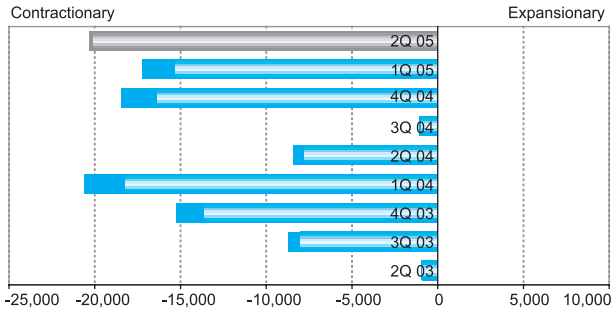
Monetary policy remained accommodative to support economic growth

Inflation edged up during the second quarter. The rise was driven mainly by cost adjustments arising from higher input prices. Demand driven price increases were moderate and were not a source of concern for monetary policy. Consequently, the monetary policy stance remained unchanged with the Overnight Policy Rate (OPR) being maintained at 2.70% during the quarter. Meanwhile, the daily weighted average of the overnight interbank rate moved in the range of 2.67-2.73%, averaging 2.70% during the quarter. The average interbank rates for the 1-week to 3-month tenures increased marginally, reflecting expectations of some market participants that interest rates will increase going forward.

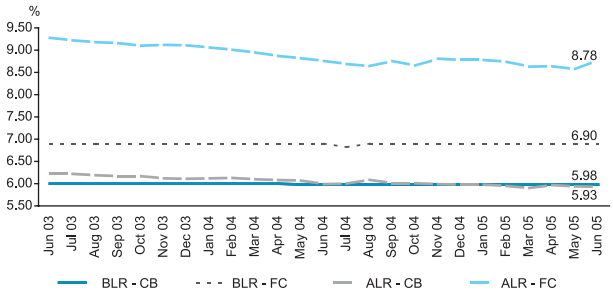
Daily Weighted Average Overnight Interbank Rate



BNM Liquidity Operations
(During the quarter, RM m)



Lending Rates of Commercial Banks & Finance Companies
(average for the month)



Interest Rates

	2Q 04	4Q 04	2Q 05
	At end-period (%)		
Overnight Policy Rate (OPR)*	2.70	2.70	2.70
Interbank rates			
Overnight	2.69	2.69	2.69
1-month	2.83	2.77	2.83
Base lending rates (BLR)			
Commercial banks	5.98	5.98	5.98
Finance companies	6.90	6.90	6.90
Average lending rates			
Commercial banks	5.99	5.98	5.93
Finance companies	8.76	8.78	8.78
Fixed deposit rates			
Commercial banks			
3-month	3.00	3.00	3.00
12-month	3.70	3.70	3.70
Finance companies			
3-month	3.00	3.00	3.00
12-month	3.70	3.70	3.70

* Effective 26 April 2004, the Overnight Policy Rate (OPR) replaced the 3-month intervention rate as the indicator of the monetary policy stance.

As at end-2Q 2005, the average BLR of commercial banks (CBs) and finance companies (FCs) remained unchanged at 5.98% and 6.90% respectively. The ALR of CBs remained relatively stable at 5.93% (March: 5.90%), while the ALR of FCs increased to 8.78% (March: 8.63%) due mainly to the exclusion of two finance companies with lower than average ALRs, following mergers with their commercial banks.

Financing of the private sector remained robust

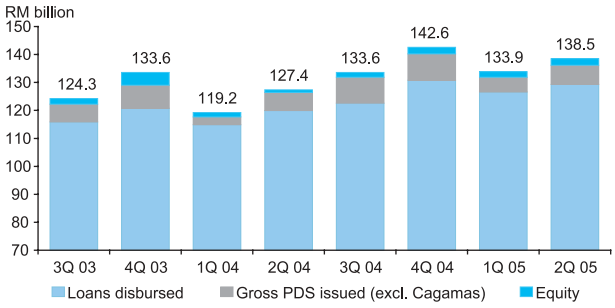
Gross private sector financing raised through the banking system and capital market in the second quarter of 2005 was slightly higher at RM138.5 billion (1Q 2005: RM133.9 billion), growing at an annual rate of 8.7% (1Q 2005: 12.3%). The increase reflected higher loans disbursed by the banking system and to a lesser extent, a larger amount of PDS issuance. On a net basis, banking system loans and PDS outstanding increased at an annual rate of 9.3% at end-2Q 2005 (9.6% at end-1Q 2005).

Financing of the Private Sector through Banking System and Capital Market

	During the period (RM billion)				Annual growth (%)		
	2004	2Q 04	1Q 05	2Q 05	2004	1Q 05	2Q 05
Gross total financing	522.8	127.4	133.9	138.5	6.2	12.3	8.7
Loans disbursed *	488.2	120.0	126.6	129.3	10.6	10.2	7.8
Gross PDS (excl. Cagamas)	28.0	6.5	5.3	6.8	-34.4	86.4	5.9
Equity	6.5	1.0	2.0	2.4	-16.7	31.6	149.2
Outstanding total financing (A)+(B)	55.6	15.9	11.1	16.0	9.0	9.6	9.3
Banking system	39.0	14.1	8.1	10.4	7.7	8.6	7.7
Loans outstanding (A)	40.1	13.6	8.6	11.3	8.5	9.1	8.4
Holding of PDS	-1.1	0.5	-0.6	-0.8	-3.1	1.3	-2.9
PDS outstanding (B)	15.5	2.3	2.5	4.7	10.7	11.2	12.6
Memorandum item							
Gross PDS (incl. Cagamas)	36.3	7.5	5.5	7.8	-28.7	-9.2	4.3

* Banking system loans include loans sold to Cagamas.

Gross Private Sector Financing through Banking System and Capital Market



Major loan indicators showed sustained lending activity. Total applications, approvals, and disbursements in the second quarter were all higher on both a quarter-on-quarter and on a year-on-year basis. While the household sector continued to be the main driver of loan expansion, lending to businesses also continued to increase.

Loans by Sector

	Loans disbursed					Loans out-standing
	During the period				Share of total	Share of total
	2004	2Q 04	1Q 05	2Q 05		
	RM billion				%	
Business enterprises	335.3	82.8	86.9	87.8	67.9	41.7
Large corporations	*234.9*	*58.0*	*61.0*	*60.7*	*47.0*	*24.5*
SMEs	*100.4*	*24.8*	*25.9*	*27.1*	*21.0*	*17.2*
Households	130.3	31.5	33.9	35.4	27.4	52.6
By sector						
Agriculture, hunting, forestry and fishing	13.7	3.7	3.1	3.1	2.4	2.1
Mining and quarrying	2.0	0.4	0.5	0.3	0.3	0.2
Manufacturing	121.5	30.7	30.9	32.2	24.9	11.8
Broad property sector	88.8	21.7	22.0	22.3	17.3	40.9
Construction	*30.3*	*7.3*	*7.4*	*7.4*	*5.7*	*5.7*
Purchase of residential property	*38.8*	*9.7*	*9.2*	*9.4*	*7.3*	*26.4*
Purchase of non-residential property	*12.1*	*2.9*	*3.5*	*3.5*	*2.7*	*6.2*
Real estates	*7.5*	*1.9*	*1.9*	*2.1*	*1.6*	*2.7*
Electricity, gas and water supply	6.4	1.5	1.4	2.2	1.7	0.9
Wholesale, retail, restaurants and hotels	83.7	20.0	22.3	24.2	18.7	8.6
Transport, storage and communication	9.5	2.8	1.9	2.2	1.7	1.8
Finance, insurance and business services	36.5	8.8	11.1	7.6	5.9	5.8
Total	**488.2**	**120.0**	**126.6**	**129.3**	**100.0**	**100.0**

Source: Bank Negara Malaysia

Loan Indicators

	During the period (RM billion)				Annual Growth (%)			
	2004	2Q 04	1Q 05	2Q 05	2004	2Q 04	1Q 05	2Q 05
Total								
Loan applications	273.3	70.5	68.4	80.7	20.1	32.9	16.9	14.6
Loan approvals	173.6	46.6	42.6	47.3	13.6	21.4	14.6	1.6
Loan disbursements	488.2	120.0	126.6	129.3	10.6	14.8	10.2	7.8
Loan repayments	461.6	110.3	117.9	120.6	7.3	14.0	4.8	9.3
Change in loan outstanding *	40.1	13.6	8.6	11.3	8.5	6.2	9.1	8.4
Of which:								
Business enterprises								
Loan applications	149.9	37.9	36.3	42.4	20.0	33.5	19.0	11.7
Loan approvals	84.9	23.6	20.0	21.7	9.8	18.4	16.3	-8.0
Loan disbursements	335.3	82.8	86.9	87.8	10.5	15.8	11.1	6.1
Loan repayments	319.8	76.0	82.6	84.7	6.8	14.6	9.3	11.5
Change in loan outstanding *	5.5	5.4	-0.1	2.8	2.6	0.2	2.8	1.5
SMEs								
Loan applications	54.2	14.5	13.1	16.4	21.7	49.1	24.4	12.9
Loan approvals	31.6	8.4	8.1	9.0	22.0	43.3	40.8	7.2
Loan disbursements	100.4	24.8	25.9	27.1	15.3	29.5	9.6	9.2
Change in loan outstanding *	6.3	2.9	1.2	2.0	7.7	7.3	10.5	9.0
Large corporations								
Loan applications	95.7	23.4	23.2	26.0	19.1	25.3	16.2	10.9
Loan approvals	53.3	15.2	12.0	12.7	3.7	8.0	4.1	-16.4
Loan disbursements	234.9	58.0	61.0	60.7	8.6	10.7	11.7	4.7
Change in loan outstanding *	-0.8	2.5	-1.2	0.9	-0.6	-3.8	-2.0	-3.1
Households								
Loan applications	120.2	32.3	31.0	37.2	22.1	29.9	14.0	15.3
Loan approvals	86.8	22.8	21.9	25.3	20.5	25.5	13.3	11.2
Loan disbursements	130.3	31.5	33.9	35.4	13.9	15.4	10.0	12.6
Loan repayments	107.0	25.6	28.1	28.1	13.7	18.4	4.6	9.8
Change in loan outstanding *	33.3	8.0	8.7	9.0	14.4	13.5	15.2	15.1

* The annual growth is for end-period.
Source: Bank Negara Malaysia

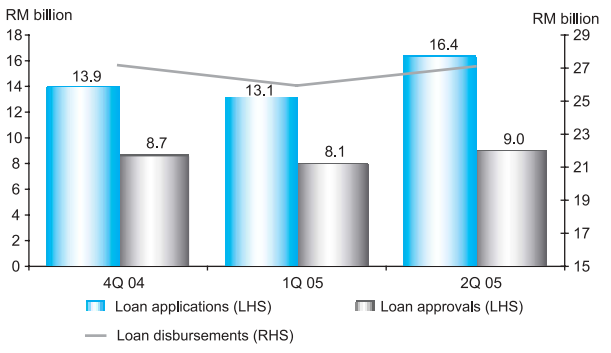
Loan applications and disbursements to households expanded at a stronger pace, indicating sustained demand for bank financing by households. On a year-on-year basis, loan disbursements for credit card spending (28.5% of total disbursements to households) and the purchase of passenger cars (28%) drove the expansion in loan disbursements to households, with annual growth rates of 16.7% and 40.5%, respectively. Meanwhile, disbursements for the purchase of residential properties were slightly lower (-3% compared with 2Q 2004). Growth in household loans outstanding was sustained, increasing at an annual rate of 15.1% at end-2Q 2005 (end-1Q 2005: 15.2%).

Lending to businesses remained resilient. Applications remained strong, expanding at an annual rate of 11.7%. Approvals remained firm on a quarter-on-quarter basis, but were lower on an annual

basis, largely reflecting the higher base effect of 2004. Disbursements, which were higher by 6.1% on an annual basis, were channelled mainly to the manufacturing sector (36.7% of total disbursements to businesses), and the wholesale, retail, restaurants and hotels sector (27.5%). Disbursements to the wholesale, retail, restaurants and hotels sector were particularly strong (21.1% higher than in 2Q 2004). Loans outstanding registered the third consecutive quarter of positive annual growth, increasing at an annual rate of 1.5% at end-June. The gross NPL ratio of business loans continued to decline (12.4% at end-2Q 2005; 13.7% at end-2004).

Lending to SMEs continued to drive growth of loans to businesses, with loans outstanding to SMEs growing at an annual rate of 9% at end-2Q 2005 (10.5% at end-1Q 2005). Sustained strong demand by SMEs for bank financing was reflected in the high growth rates of applications (+12.9%) and disbursements (+9.2%). A total of RM9 billion was approved to 21,421 SME accounts during the quarter (1Q 2005: RM8.1 billion approved to 19,709 accounts).

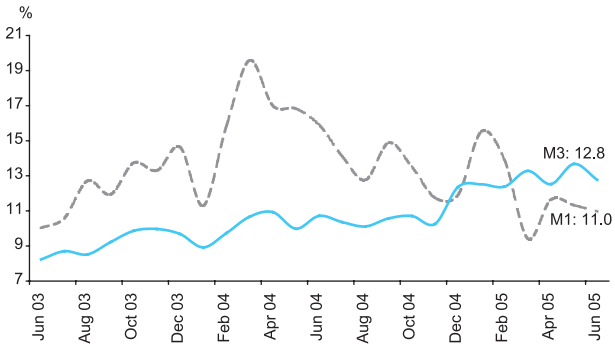
Bank Lending to SMEs



Growth in monetary aggregates were relatively stable during the quarter

Narrow money, M1, increased at an annual rate of 11% at end-2Q 2005 (end-1Q 2005: 9.4%). Broad money, M3, grew at an annual rate of 12.8% at end-2Q 2005 (end-1Q 2005: 13.3%), driven mainly by the inflows of funds and sustained lending activity by the banking system, which were partially offset by the lower net claims on the Government.

Monetary Aggregates: Annual Change



M3 Determinants

	Change during the year			
	Yearly	Quarterly		
	2004	2Q 04	1Q 05	2Q 05
	RM billion			
M3	68.0	9.9	26.4	8.3
Net claims on Government	-15.9	-2.0	-9.1	-4.5
Claims on private sector	30.0	12.2	8.1	7.5
Net external operations*	82.0	6.0	29.0	12.9
Other influences	-28.1	-6.4	-1.7	-7.6

* Pre-revaluation

Financing through the capital market remained substantial

During the second quarter, the financing requirements of both the public and

private sectors were effectively met by the capital market. Net funds raised from the capital market remained substantial at RM7.6 billion (1Q 2005: RM10.5 billion), with the bulk of the financing raised from the bond market.

Gross financing sourced from the private debt securities (PDS) market was higher, amounting to RM7.8 billion (1Q 2005: RM5.5 billion), supported by the prevailing low yields in the bond market. During the quarter, a total of 26 corporations, mainly from the utilities, transportation and storage sectors, sought financing from the PDS market. The funds were raised mainly to finance new activity (52.8% of new issuances) and to refinance their existing debt (35.4% of new issuances). In terms of instruments, medium term notes and Islamic debt securities were the preferred form of issuance, representing 49.3% and 43.5% of total issuances respectively. During the quarter, the International Bank for Reconstruction and Development issued a 5-year RM760 million Islamic bond, making it the third supranational issuance from the ringgit bond market. After adjusting for redemptions, net funds raised through the PDS market totaled RM3.7 billion (1Q 2005: RM1.3 billion).

The Government raised a gross total of RM9.6 billion through the issuance of four Malaysian Government Securities (MGS) during the quarter. However, after accounting for the high level of redemptions, net funds raised by the public sector were lower at RM1.4 billion (1Q 2005: RM7.2 billion).

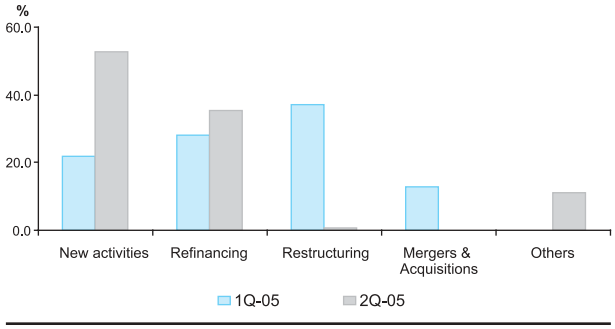
Financing through the equity market increased to RM2.4 billion (1Q 2005: RM2 billion). The bulk of the funds were raised through 14 initial public offerings (IPOs) totaling about RM2 billion, including two major IPOs, which accounted for a total of RM1.7 billion. During the quarter, there were 16 new listings on Bursa Malaysia, with three listings

Funds Raised in the Capital Market

	2004		2005		
	2Q	1H	1Q	2Q	1H
	RM million				
By Public Sector					
Government Securities, *gross*	14,763	25,763	4,000	9,543	13,543
Less Redemptions	9,700	15,200	-	8,500	8,500
Less Government holdings	-	-	-	-	-
Equals Net Federal receipts	5,063	10,563	4,000	1,043	5,043
Khazanah Bonds, *net*	(1,000)	(1,000)	833	-	833
Govt. Investment Issues, *net*	(560)	(560)	2,000	-	2,000
Merdeka Savings Bond, *net*	497	542	357	378	735
Net Funds Raised	4,001	9,546	7,190	1,421	8,611
By Private Sector					
Shares	969	2,496	2,009	2,415	4,424
Debt securities	7,498	13,539	5,486	7,823	13,309
Private Debt Securities (PDS)	6,463	9,299	5,286	6,843	12,129
Cagamas	1,035	4,240	200	980	1,180
Less Redemptions	8,558	15,486	4,212	4,078	8,290
Net Issues	(1,060)	(1,947)	1,274	3,745	5,019
Net issues (excluding Cagamas)	(2,095)	(2,017)	2,634	3,380	6,014
Net Funds Raised	(91)	549	3,282	6,161	9,443
Total Net Funds Raised	3,910	10,095	10,473	7,582	18,054
Short-term Papers and Notes, *net* [1]	(1,213)	(1,482)	587	82	669
Total	2,697	8,614	11,059	7,664	18,723

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

Private Debt Securities Issued by Purpose
(% of total)

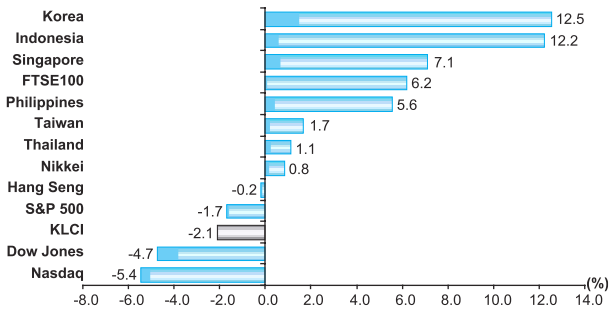


on the Main Board, three on the Second Board and ten on the MESDAQ Market.

KLCI performance was mixed in the second quarter

Concerns over the adverse impact of rising oil prices and higher domestic inflation dampened market sentiments in the first two months of the quarter. However, the market improved in June. Consequently, for the second quarter as a whole, the performance of the KLCI improved by 16.97 points, ending the

Performance of Selected Global and Regional Markets in the Second Quarter of 2005
(31 December 2004 - 30 June 2005)



Bursa Malaysia: Selected Market Indicators

	As at end				
	2004		2005		
	2Q	1H	1Q	2Q	1H
Price Indices					
- Composite	819.86	819.86	871.35	888.32	888.32
- EMAS	197.34	197.34	204.98	203.73	203.73
- Second Board	117.17	117.17	101.76	87.79	87.79
Average daily turnover					
- Volume (million units)	332.73	486.39	517.97	416.52	461.71
- Value (RM million)	726.12	1,017.11	965.78	651.99	797.01
Market Capitalisation (RM b)	653.94	653.94	694.89	688.63	688.63
No. of Companies Listed	934	934	982	990	990

Source: Bursa Malaysia

Bursa Malaysia: Turnover of Corporate Securities

	2004				2005					
	2Q		1H		1Q		2Q		1H	
	million units	RM million	million units	RM million	million units	RM million	million units	RM million	million units	RM million
Turnover	20,478	43,964	56,648	117,832	30,042	56,261	25,824	40,423	55,867	96,684
of which:										
Main Board	14,826	37,062	41,237	95,923	21,236	48,384	18,253	35,778	39,489	84,162
of which										
- Consumer Products	782	2,605	1,879	6,355	1,018	3,117	872	2,072	1,890	5,189
- Industrial Products	2,211	3,663	6,109	9,429	4,829	5,767	2,996	3,076	7,825	8,842
- Construction	862	1,911	2,486	5,783	1,579	3,114	810	1,287	2,389	4,401
- Trading/Services	3,509	12,723	8,897	31,898	4,320	15,710	4,055	14,160	8,375	29,870
- Finance	2,342	7,728	6,699	21,694	3,059	10,495	2,173	8,253	5,232	18,748
- Properties	2,155	2,978	6,143	7,909	3,367	5,602	3,767	3,069	7,134	8,671
- Plantations	539	2,779	1,259	5,713	604	2,168	453	1,951	1,057	4,119
- Mining	5	30	47	164	0	1	0	7	0	8
Second Board	4,018	5,468	10,051	16,303	5,537	5,586	4,194	2,960	9,731	8,546

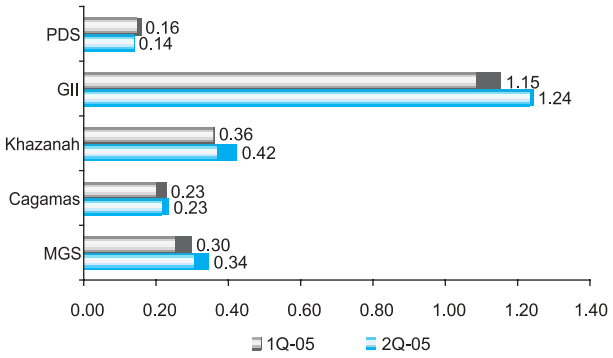
Source: Bursa Malaysia

quarter higher at 888.32 (1Q 2005: +1.9%). However, market capitalisation was lower at RM688.6 billion (1Q 2005: RM694.9 billion). Trading activity during the quarter declined with a lower average daily turnover of 417 million units (1Q 2005: 518 million units).

Lower secondary trading in the bond market

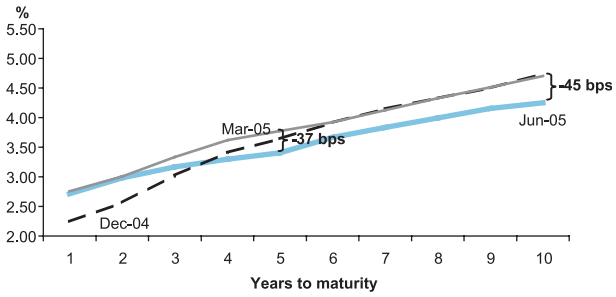
In the secondary market, total trading declined to RM94.5 billion in the second quarter (1Q 2005: RM98.8 billion). Government securities accounted for 62.5% of the total trade, while Cagamas bonds and Khazanah bonds contributed 10.3% of the total trade. In terms of liquidity, the GII and Khazanah bonds were the most liquid papers, registering liquidity ratios of 1.15 and 0.36 respectively

Liquidity Ratio: Turnover / Outstanding



The MGS benchmark yields declined significantly due mainly to the greater demand for fixed income securities from domestic institutional investors given the high redemption of MGS during the quarter. The renewed interest on Government securities by non-resident investors exacerbated the decline in MGS yields. In addition, the bond market sentiment was also influenced by concerns over the impact of higher crude oil prices on the global economic growth. As a result, the MGS yields curve shifted downwards, with the 5-year and 10-year MGS declining by 37 and 45 basis points respectively.

Trend in MGS Yield



Performance of the ringgit

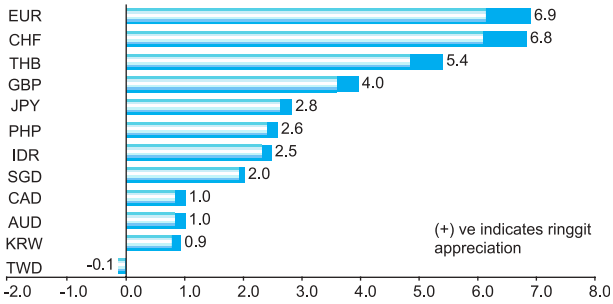
The ringgit appreciated against major and regional currencies during the second quarter. The US dollar had strengthened against the major currencies amid expectations of further tightening of US monetary policy to mitigate inflationary pressures, yield differentials favouring dollar assets, as well as market expectations that US economic growth for 2005 will outpace that of the euro area and Japan. Concerns over the future of European economic integration following the negative outcome of the French and Dutch referendum on the new EU Constitution also weakened sentiments towards the euro.

The US dollar, and hence the ringgit, also appreciated against regional currencies during the second quarter. Several

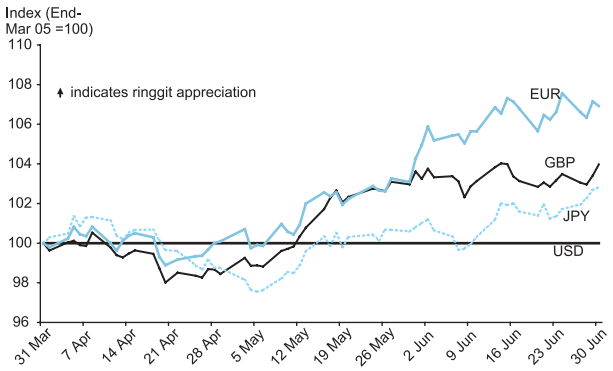
regional currencies were weighed down by concerns over the impact of rising international oil prices on the growth prospects of regional economies. The decline in the Thai baht was partly due to concerns over the impact of high oil import costs on the current account.

The appreciating trend of the dollar and hence the ringgit against other currencies during the second quarter, have to a large extent reversed the depreciation experienced in 2004. This has caused the trade-weighted value of the ringgit to become close to its fair value.

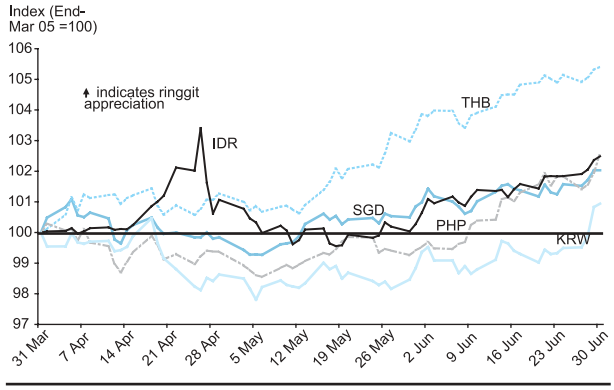
Summary of Ringgit Performance Against Selected Currencies
Percent Change (1 April - 30 June 2005)



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	2Q 04	1Q 05	2Q 05	30 Jun 97	02 Sep 98	2Q 04	1Q 05
US dollar	2.5235	3.8000	3.8000	3.8000	3.8000	-33.6	0.0	0.0	0.0
Euro	-	-	4.5933	4.9125	4.5948	-	-	0.0	6.9
Pound sterling	4.1989	6.3708	6.8719	7.1415	6.8685	-38.9	-7.2	0.0	4.0
100 Japanese yen	2.2088	2.7742	3.4991	3.5446	3.4469	-35.9	-19.5	1.5	2.8
Singapore dollar	1.7647	2.1998	2.2139	2.3034	2.2576	-21.8	-2.6	-1.9	2.0
100 Thai baht	9.7470	9.3713	9.2841	9.7013	9.2032	5.9	1.8	0.9	5.4
100 Philippine peso	9.5878	8.8302	6.7640	6.9381	6.7628	41.8	30.6	0.0	2.6
100 Indonesian rupiah	0.1038	0.0354	0.0404	0.0401	0.0391	165.4	-9.5	3.2	2.5
100 Korean won	0.2842	0.2827	0.3298	0.3734	0.3699	-23.2	-23.6	-10.8	0.9

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

DEVELOPMENTS IN THE BANKING SYSTEM

The banking system showed greater resilience in the second quarter of 2005. Capitalisation remained strong, accompanied by continued growth in profits and improvements in the quality of the loan portfolio enabling the banking system to register robust lending activities.

Capitalisation remained strong

The capital position of the banking system remained strong, albeit recording a slight decline in both the risk-weighted capital ratio (RWCR) and core capital ratio (CCR) to 13.3% and 10.4% respectively as at end-June 2005. The decline was due primarily to an increase in risk-weighted assets of RM25.1 billion (+4.3%) as a result of the inclusion of market risk in the capital adequacy framework that was made effective from 1 April 2005. This increase, coupled with higher lending activities, offset the expansion in capital base of RM0.7 billion (+0.9%).

Banking System: Capital Position

	2004				2005	
	1Q	2Q	3Q	4Q	1Q	2Q
Capital						
CCR (%)	11.0	11.7	11.4	11.3	10.9	10.4
RWCR (%)	13.7	14.3	13.9	14.3	13.8	13.3

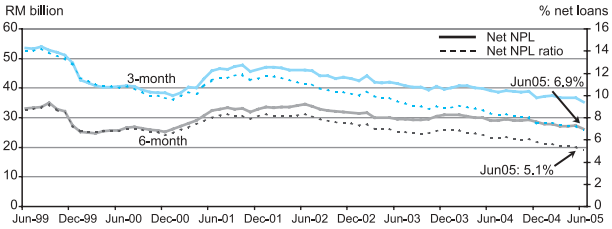
Improved profitability

Pre-tax profits of the banking system rose by RM0.3 billion (+10.9%) to RM3.1 billion during the second quarter of 2005. The growth was attributed mainly to higher operating income, driven by higher investment income (+RM0.3 billion or +97.8%) and net interest income (+RM0.4 billion or +7.3%). Despite a slight increase in loan loss provisions of RM0.3 billion, the annualised return on average assets and equity of the banking system remained strong at 1.4% and 17.3% respectively (1Q 2005: 1.3% and 15.6% respectively).

Continued improvements in NPLs

Improvements were evident in the asset quality of the banking system, where net non-performing loans (NPLs) based on the 6-month and 3-month classifications

Banking system: Non-performing loans



declined to RM26.1 billion and RM35.2 billion respectively. This resulted in the net NPL ratios improving to 5.1% (1Q 2005: 5.4%) based on the 6-month classification, and 6.9% based on the 3-month classification (1Q 2005: 7.3%). The improvement was due primarily to lower incidences of new NPLs, continued write-offs and higher reclassification of NPLs to performing accounts.

Second Islamic Financial Services Board Summit
24 May 2005

"The Rise and Effectiveness of Corporate Governance in the Islamic Financial Services Industry"

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

"The hallmark of the Islamic financial system lies in the high ethical values that underpins the governance and business operations of Islamic finance. As the pace of development of the industry accelerates and as the environment becomes increasingly more complex and challenging, securing a robust and resilient financial system has increased the demands for having a solid governance structure for the Islamic financial institutions. The challenge is essentially to evolve strategies that will promote the adoption of strong and effective corporate governance practices that also facilitates innovation and that supports business operations. Central to this common vision is to create a comprehensive governance framework for Islamic institutions and to formulate appropriate implementation strategies that will be able to meet the requirements of the dynamic industry while promoting confidence and stability in the Islamic financial system."

While the adoption of governance best practices is not an end in itself, it is an important supporting infrastructure that is vital to achieving high performance and the continued advancement of the industry. Strengthening the robustness of the corporate governance framework and practices has become even more important in today's environment of greater uncertainty and heightened risks. Indeed, it is timely that efforts are focused to strengthen the corporate governance in Islamic financial institutions given the wider range of contracts entered into by the Islamic financial institutions and their customers that inherent in Islamic finance. In particular, the efforts should include the formation of an appropriate governance structure of the institution and the requirement for full disclosure.

My remarks today will focus on five key areas important for securing an enhanced governance framework for the Islamic financial institutions that takes into account the role and responsibilities of the shareholders. My presentation will also touch on the experience and approach that Malaysia has adopted to secure a robust governance framework for the Islamic financial institutions.

Firstly, the task is to ensure the design and implementation of the corporate governance strategy should not impose a regulatory burden to the business objectives and the growth potential.

In designing and implementing corporate governance standards and core principles for Islamic financial institutions, the challenge is to formulate a framework that does not only take into account the unique characteristics peculiar to Islamic financial business, but that fosters innovation and competition thereby support the growth potential of the industry. Essentially, the design and strategies needs to secure the twin objectives of achieving continuous business performance and robust corporate accountability.

As the level of innovation increases in a more liberalised and deregulated environment, a governance framework that is more principle-based rather than rule-based becomes relevant. The approach would thus need to develop the broad but clear guidance, standards and core principles rather than prescriptive rules and regulations. The process would involve identifying the risks and ensuring that the institutions have the capacity and mechanisms of internal controls and the systems to undertake and manage the recognized risks.

While good governance is indispensable, the relevant principles needs to be applied in a manner that is in harmony with the nature of the different transactions peculiar to Islamic finance. In particular, the framework should endeavour to engender the support of all the stakeholders of the Islamic financial institutions. This entails having in place the systems that will ensure that the obligations to all the major stakeholders - the customers, depositors, investors, entrepreneurs, owners and the community at large - are met with integrity and with adherence to the rules and regulations. Indeed, in an environment where businesses needs to balance between the interests of the various stakeholders which at times could be conflicting, an appropriate governance framework for active checks and balances becomes particularly important. While the roles of shareholders and board of directors are certainly critical, it should not diminish the roles of the other stakeholders.

Secondly, there must be robust corporate governance framework at the institution level with the shareholders and the board as key players.

At the institution level, corporate governance is essentially about how the company is managed and controlled and the manner to ensure proper accountability for those in-charge. Central to the corporate governance framework is thus to ensure integrity, strong internal controls and risk management practices. In this connection, the shareholders' greatest influence is in the appointment of both the independent and non-independent directors; to ensure the selection of those who are able to set clear direction and drive for effective corporate governance at the institutional level. The shareholders have a role to ensure that the board comprises a good mix of competent persons with relevant experience to provide effective representation.

The board of directors must be able to protect the long-term objectives of the institution and provide leadership for good governance by setting a clear corporate governance framework for the institution, and

effectively monitoring its implementation. The institutional broad governance framework will serve as the focal point of reference for management and staff in relation to corporate governance. It is also a manifestation of the institution's vision and strategy to achieve good governance whereby shareholders and other outside stakeholders are able to evaluate the level of commitment of the institution towards enhancing good governance.

Islam strongly advocates all forms of positive governance. The design of the framework however, should not be made in isolation of the universal values expounded in the existing governance principles and standards that are consistent with Islamic principles. This framework must set out the functions of each component and level of governance in a manner to ensure accountability of each respective jurisdiction with appropriate division of powers to avoid possible conflict of interests. In this context, consideration may be given to four main ingredients important to the governance framework for Islamic financial institutions.

(i) Firstly, to ensure that the guidance, standards and core principles are able to translate the values consistent with the injunctions of Shariah. The core values of honesty and integrity are key ingredients of the governance framework of the Islamic financial transactions with heavy reliance on the trust relationship. The significance of these core values is clearly highlighted in the Qur'an, Sunnah and the "fiqh". The banking institutions, as user of public funds must act in good faith for the benefit of all stakeholders. If the relationship between the financier and entrepreneur can be built on honesty, efficiency and equity, a durable equilibrium can be established that will serve the mutual interest of both parties.

(ii) Secondly, the governance framework needs to take into account the multi-faceted role performed by the Islamic financial institutions and treat all the relevant stakeholders fairly, including minority shareholders and the investment account holders. It is an embodiment of the concept of justice in Islam as stated in Qur'an, which is nearest to righteousness (taqwa) in the Islamic faith.

(iii) Thirdly, that the Shariah governance framework must be put in place as an additional dimension and a distinct feature in the governance structure of Islamic financial institutions. This is crucial in instilling public confidence on the purity of the operations of the Islamic financial institutions. The Shariah Board or Committee therefore represents another stratum in the governance structure. The Shariah Committee serves to ensure that the management of the Islamic banking institutions are in compliance with Islamic principles.

(iv) Fourthly, the framework should promote greater transparency and higher level of disclosure to address information asymmetry of the different stakeholders in the different structures of the transactions in Islamic finance thereby facilitating the effective functioning of market discipline. This is critical for the investment account holders who are in the position to influence the Islamic financial

institutions if they were given adequate information on the investment strategy and results, as well as the applicable rate of return. The disclosure would also allow the market to assign appropriate risk premiums to respective companies and thereby enforce effective market discipline.

The third key area is to strengthen existing mechanisms to translate Islamic values into business operations and governance.

With the broad governance framework in place, the Islamic financial institution needs to have adequate mechanisms for effective implementation of the framework. This includes the systems of internal controls, internal and external audit, risk management, transparency and disclosure, and a strong compliance culture. It also includes having in place the nominating and remuneration committee to ensure the right persons for the job are appointed and that the reward or penalty are commensurate with the accountability and performance. Indeed the Prophet refers to this in the words, "whoever employs a person out of favouritism and there is someone who is better than that person, he has committed breach of trust with God, His prophet and all Muslims".

The risk management committee needs to review the risks peculiar to Islamic finance and consider the means by which they should be managed. Expertise needs to be developed to address the audit for the Shariah risk. The audit committee therefore needs to examine not only the risks associated with banking operations, but also complementing the Shariah Committee in ensuring full compliance with the Shariah principles. The role of the Shariah Committee may also be expanded beyond product approval, in particular to strengthen the governance of the Islamic financial institutions by ensuring for each new product, proper disclosure is made and the rights of the customers and the responsibilities of the Islamic banking institutions are clearly provided.

Fourthly, the role of the regulator in strengthening the standards and best practices in inculcating good governance.

The government and regulator has an important role in putting in place an enabling environment that supports the development of a strong governance structure and that provides for enforcement.

In Malaysia, corporate governance reform is a priority agenda. Malaysia has adopted a hybrid approach towards governance reform that includes legal reform, self-regulation as well as measures to encourage market-based regulation. The approach balances between prudential regulation, market discipline and shareholders surveillance. Malaysia has proceeded on the basis that there are aspects of corporate governance where statutory regulation is effective and necessary and in others where self-regulation is more appropriate. Building the necessary legal and institutional framework to support the development of good corporate governance practices within the capital and financial markets is therefore an important part of the process.

Among the various measures initiated includes the law that provides the statutory framework to protect the interest of the depositors, customers and shareholders as well as the prudential framework to promote financial stability. This includes the legal provisions prescribing the maximum permissible shareholding limit to avoid concentration of ownership. There is also a restriction on extension of credit to related parties to avoid conflict of interest, as well as a limit on the lending to single customer. Other measures include the issuance of specific guidelines on the role and responsibilities of directors and the creation of various board committees. Greater emphasis is also accorded to the role of independent directors, minimum qualifications of such directors and their compensation to ensure sufficient independence to act in the best interest of the institution.

In the area of Shariah governance, guidelines have been issued on the governance structure of the Shariah Committee in the Islamic financial institutions. The guidelines define the role and responsibilities of the Shariah Committee, which extends beyond endorsement of Shariah-compliant products to also ensure that the operations of the Islamic banking institution complies with Shariah requirements at all times. The guidelines also prescribe the fit and proper criteria for members of the committee, and places emphasis on the independence of the committee to report directly to the Board and to accord to the Board the responsibility to ensure that the Shariah Committee can effectively discharge its duties. In addition, members of the Shariah Committee may not sit on the Shariah Committee of other Islamic banking institutions as well as on the Shariah Advisory Council of the Central Bank so as to preserve the confidentiality and avoid potential conflict of interests.

To promote greater financial transparency and disclosure and to safeguard the interests of investment depositors, guidelines have also been issued on the model financial statement of the Islamic banks. In this connection, Islamic banking institutions are required to provide disclosure of information, among others, on the segregation of income and expenses from the categories of instruments including the investment of unrestricted investment deposits, restricted investment deposits and investment of shareholder's funds. Islamic banking institutions are also required to disclose information on the profit equalization reserves.

In addition to disclosure requirements in the financial statement, a standard framework for the calculation of the rate of return for Islamic banking operations has been introduced. The framework requires Islamic banks to clearly segregate the income and expenses of the Islamic banking operations based on the management of funds, on a restricted and unrestricted basis. The framework provides the basis for calculation of dividends to the investment depositors to reflect the average actual net rate of return of each deposit based on their respective tenures. An accurate calculation of dividends is essential to ensure that the investment depositors receive their fair share of investment returns. In addition, the framework

allows the provision of profit under the profit equalization reserve mechanism for the purpose of smoothing the fluctuations in the rate of profit.

Finally, amplifying the role of other standard setting bodies.

As Islamic finance expands, there are common areas where collective efforts by the Islamic financial industry, including the domestic and international standard setting bodies can bring benefits to the overall financial system.

In this regard, bankers associations have an important role in spearheading initiatives to promote high standards of ethical code of market conduct to meet consumers' rising expectations and demands. Bankers associations can play an important complementary role to the efforts of the regulatory authorities' in promoting a more progressive, dynamic and resilient banking system. For the Islamic financial services industry, there are several areas of common interest that the industry associations can contribute to strengthen corporate governance.

In the international scene, AAOIFI has made contributions towards improved quality of financial statements and reporting methodology of the Islamic institutions via issuing accounting and auditing standards for Islamic financial institutions. Standards and code of ethics have also been issued to govern the conduct of the accountant and auditors of the Islamic institutions. Undoubtedly, the efforts by AAOIFI have assisted to accelerate the pace of transparency and corporate governance of the Islamic financial institutions in the international environment.

Needless to say that the role of Islamic Financial Services Board is crucial in enhancing the level of transparency and quality of corporate governance of the Islamic financial institutions. The Islamic Financial Services Board through the promulgation of the international prudential standards on corporate governance that are consistent with Shariah principles will have a prominent role in promoting prudent, transparent and robust development of Islamic financial services.

Conclusion

Good governance is essentially participatory, transparent and accountable. These elements are embedded in Islam and therefore an integral part of the governance framework of the Islamic financial institutions. Consequentially, effective Islamic governance framework requires involvement of all stakeholders - the government, the industry associations, the shareholders, the directors, the management and other persons relevant to the business such as auditors, accountants, lawyers and Shariah advisors - to responsibly complement each other in providing checks and balances, and in strengthening the corporate governance practices. At the international level, the Islamic Financial Services Board and other standard setting bodies have an important role to harmonise the practices and complete the framework by setting the broad governance framework for international

application. It is with this integrated and cumulative approach, that strong and effective corporate governance framework will be successfully implemented. Each one of us regardless of our position, as regulators or bankers, is accountable. Let me conclude with reference to the saying of the Prophet, "Each one of you is a guardian, and each guardian is accountable to everything under his care".

Islamic Bankers' Forum 2005
21 June 2005, Putrajaya

"Islamic Finance: Promoting The Competitive Advantage"

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

"Islamic finance has become a competitive form of financial intermediation that has been able to meet the differentiated requirements of our economies. In an environment of rapid change, a key factor that will influence the future prospects of the Islamic financial services industry will be the investments to build the foundations on which further progress can be achieved. Investing in the future, in research and development and in the development of talent and expertise will be the differentiating factor that will contribute to the effectiveness, resilience and competitiveness of the industry. This undertaking needs to be the joint responsibility of both the private and public sectors to mutually elevate the performance of the industry and thus increase its potential to contribute to wealth creation and prosperity of our nations."

It is my honour to be invited to speak at this Islamic Banker's Forum organized by the General Council for Islamic Banks and Financial Institutions (CIBAFI) on the strategic approach in developing a progressive Islamic financial system. The occasion of this Forum is indeed an excellent opportunity for the industry practitioners, regulators and academia to deliberate on the key issues that are important to the future of the Islamic financial services industry. My remarks today will focus, in particular, on the issues relating to innovation, which is indeed derived from the investment in research and development, and from the investment in the workforce in the sector.

Innovation is key to sustaining growth and securing the competitive advantage. Innovation is about developing new Islamic financial products and services and increasing the range of products and services to meet the more sophisticated and complex requirements of today's consumers and businesses. It is also about improving the overall efficiency by which the products and services are being provided. Innovation will also involve the introduction of new structures that may contribute towards enhancing convenience for consumers and businesses. Finally, it may also contribute towards creating new markets or expand the existing markets for Islamic products and services. Industry practitioners thus have an important role to promote innovation. Financial institutions need to equip their business strategies with research and development to design new innovative products and services. Such innovative financial products and services which are

credible, competitive and Shariah-compliant would indeed find a ready market. The introduction of the global sovereign sukuk more than two years ago was an important innovation that has since gained significant ground.

Innovation can also take the form of the application of technology to improve convenience for customers and reduce the cost of financial transactions. In embracing new leading-edge technology, the potential for the Islamic financial industry to provide new products and services will be enhanced. It also represents the potential to increase access to financial products through a wider range of new delivery channels. Greater application of IT in the industry can also enhance efficiency by driving down costs for consumers and businesses. Other areas include leveraging on IT in making strategic decisions in the alignment of business, in elevating institutional capacity and operational efficiency and strengthening risk management capabilities. Moving forward, the enhancement of technological capabilities becomes vital for the financial industry as it competes in an increasingly technology-driven environment.

The environment and the incentive structure is also important in providing an enabling environment that promotes innovation. In particular, the regulatory framework and the tax structure are important to the innovation process. The regulatory framework should not be so onerous as to impose a high cost and a regulatory burden on businesses. Intrusive regulatory approaches on new products can become a disincentive to innovation. Tax structures can also be designed to support the innovation process. Within financial institutions, organisational structures can also create an environment for innovation by aligning the organization's processes and implementing appropriate performance incentives.

The pace of innovation that has taken place in the Islamic financial services industry has contributed to the development of a broad and diversified range of Islamic financial products and services that has been able to effectively mobilize financial resources to meet the investment requirements of the economy. Notwithstanding this significant progress, the process of innovation in Islamic finance has generally been structured mainly along the adaptation approach. Although there are Islamic financial instruments that are distinct from the conventional financial instruments, the numbers are still few. In most instances, the Islamic financial products are repackaged along the features of the conventional financial products, while eliminating the elements that are not in compliance with the Shariah.

The Islamic financial services industry is now at the threshold of a new level of development. As we advance forward, the Islamic financial services industry can expect to have a different set of regulatory and supervisory standards which is conducive to its unique financial operations. There is also an increased awareness and understanding amongst the international financial community on the distinct nature of Islamic banking and financial operations. In addition, a higher degree of Shariah dynamism is evident in the evolution of sophisticated Islamic financial products that are being structured based on

multiple Shariah concepts. Against these developments, it is timely to move away from "plain vanilla" innovation and to embrace a new wave of innovation that will evolve Islamic financial instruments into distinct products that will maximize the potential and wisdom of the Shariah and that meets the greater sophistication of consumers and the more complex requirements of today's businesses. This paradigm of innovation in Islamic finance, which by itself shall accord Islamic financial institutions with the competitive advantage to forge ahead, entails substantial and continuous investments in research and development (R&D). R&D is indeed an essential aspect of modern industries and enterprises and is no less the case in the financial world. There are three important pre-requisites in strengthening research and development capabilities, namely, adequate allocation of resources for infrastructure development, forging strategic alliances through smart partnerships and developing the required pool of qualified and skilled talent.

Adequate allocation of resources for infrastructure development

Islamic financial institutions are continually being confronted with new challenges that need to be addressed. Their institutional capacities and capabilities need to be continuously strengthened. This includes attention to continually review their strategic orientation and key priorities and the necessary adjustments that need to be made to position the institutions to effectively respond to the new developments and challenges that have emerged.

In order to meet the increasing demands of a modern and sophisticated market, financial institutions must continually invest in the supporting infrastructure that promotes research and development. This will enhance the capacity for innovation. Attention also needs to be given to the applied approach to Islamic finance and its modern practice. Financial support for advanced research at universities and research institutes will increase research opportunities. Efforts to utilise and install strong technological capabilities will also contribute to enhance research and development. In embracing the new leading-edge technology, the potential for the Islamic financial industry to develop new products and services will also be enhanced.

Forging strategic alliances through smart partnerships

To further enhance research and development (R&D) activities, the promotion of strategic alliances through smart partnerships can play an important role. Entering into strategic alliances with other entities would create greater synergy, which may bring about new approaches, new technologies and new areas of specialization. Collaborative efforts amongst Islamic financial institutions in particular, would strengthen the ability to leverage on the industry's expertise. The introduction of innovative Islamic financial products in a specific jurisdiction can be expanded to other jurisdictions, which in turn, will contribute to broaden and deepen Islamic financial markets and thus strengthen the overall development of the Islamic financial industry. In addition, active collaboration between academic researchers and the

practitioners will enable the practical application of research findings. In Malaysia, an industry-owned research and training institute in Islamic banking and finance, the Islamic Banking and Finance Institute Malaysia (IBFIM) has been established to spearhead greater collaborative efforts with universities to undertake research in areas that are key for the progressive development of the Islamic financial industry.

A highly qualified and skilled pool of talent

The fast pace of innovation in global financial services in general and for the Islamic financial services sector in particular, will demand a rapid and continuous infusion and upgrading of skills. Developing a substantial pool of talent and expertise is indispensable for strengthening research capabilities. In this regard, there has to be a strong focus on human capital development through training and education. In today's competitive environment, intellectual capital is the major factor in determining the level of innovation and competitiveness of an institution or corporation. A key challenge for Islamic financial institutions is to attract a knowledge-based workforce with the skills required to enhance the potential for innovation, productivity and performance. The Islamic financial services industry needs to continually promote human capital development and expertise to create a larger pool of experts and high calibre professionals. This involves attracting and retaining the existing talent, and building a robust pipeline of skilled individuals for the future. In addition, specialists in Islamic finance would need to combine knowledge and understanding of the Shariah with the necessary skills in finance. The provision of training and career development will have a key role in the sector. Learning systems therefore need to be strengthened to meet the skills and talent requirements of the next decade.

Training is a joint responsibility between the industry, academia and Government. In Malaysia, the Government plans to establish an international financial training institute on Islamic finance. The ground work to establish this institute has already commenced. While this may meet some of the requirements, Islamic banking institutions are also encouraged to explore the feasibility of entering into collaborative arrangements with universities and other institutions locally and abroad, to identify and provide specialized training for the financial services industry. These would include training workshops and courses in new and emerging product lines which require specialised skills and expertise.

Education of graduates and other personnel entering the Islamic financial market is also important. Undergraduate opportunities to study Islamic finance or Shariah, either as a speciality or a major component of a business degree, should be readily available at local and foreign universities. The challenge is to provide programmes which keep pace with changes in financial innovation and technology. Meeting this need requires rigorous, extended programmes such as the post-graduate programmes in Islamic Finance and Financial Engineering with emphasis on Islamic banking principles. At the same time, relevant organizations can support such programmes

by creating funds to sponsor promising students to pursue formal education, ranging from modular courses in Islamic finance to full post-graduate programmes. There is also a need to increase programmes and initiatives that provide education and training in Shariah. Islamic research organizations and financial institutions need to work towards developing a sufficient number of competent Shariah scholars who are equipped with sound knowledge and expertise in both Islamic jurisprudence and Islamic commercial laws to deal with innovative and cutting-edge products.

There is also the need for extensive education of the consumer and business community. This would increase the outreach resulting in increased demand for new and innovative products and approaches. Malaysia has implemented a 10-year structured consumer education programme to increase the level of consumer awareness on the unique characteristics of Islamic financial products and the product choices offered by Islamic financial service providers. Increased awareness will drive the demand for a broader range of Islamic products and services customized to their requirements at more competitive prices and through more convenient channels. The outreach has also been targeted at small and medium sized businesses. This process will also prompt the financial industry to increase innovation to strengthen their competitive position. This can be reinforced by market research to enhance the understanding of customers' distinct financial needs and their risk tolerance and therefore enable the design of Islamic financial instruments that offer tangible benefits and value to customers. In addition, with increased disclosure and transparency on the manner in which Islamic financial transactions are being conducted and on how Islamic financial contracts are being executed as well as on the risk and return profiles of financial products, this will further strengthen the role of competition.

In conclusion, the investment in the future needs to be undertaken by all the relevant entities in the Islamic financial sector - the industry, the regulators, the market participants, the academia and the international community. As a co-ordinated and concerted effort it will be mutually reinforcing in elevating the performance of Islamic finance. While the increasingly more competitive prevailing environment raises the pressures to produce immediate-term results, it is the investment in human capital and in research and development that will secure the long-term sustainability of the industry. It is these investments that will be the defining element of the future development of Islamic finance and its long-term success.

Seminar on 10-Year Master Plan for Islamic Financial Services Industry
22 June 2005, Putrajaya

"Building a Progressive Islamic Banking Sector: Charting the Way Forward"

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

"The Islamic financial services industry is now at the threshold of its next stage of development. This decade has seen significant progress being achieved. Islamic finance has now gained wide acceptance as a form of financial intermediation. The sustainability of this progress, however, demands due attention to the future - to look beyond the near term, and to take a longer-term perspective into the needs of the future and to evolve an Islamic financial system that will best serve these needs. An essential part of this process is the clarity of the vision and the objectives that are to be achieved. This provides the starting point for the formulation of a Master Plan which defines the blueprint for the future development of Islamic finance. While envisioning the future will provide the strategic focus and the common goal to be achieved, of greater importance will be the actions that need to be taken to make it happen."

I am most honoured to be invited to speak at this Seminar on the Ten-Year Master Plan for the Islamic financial services industry organized by the Islamic Development Bank and the Islamic Financial Services Board to discuss the key issues and considerations in the formulation of a master plan for the development of Islamic banking and finance. Our goals are to develop an efficient, progressive and comprehensive Islamic financial system that is able to contribute to the overall growth process and development. In this first session on the banking sector, the focus of my address will be on the blueprint for building a progressive Islamic banking sector. This will include a discussion of the building blocks that are necessary to provide the foundations on which subsequent enhancements can be built. I will also take this opportunity to share with you Malaysia's experience in formulating a ten-year Financial Sector Master Plan which was launched in 2001, and our experience in the implementation of the Plan, in particular, for the development of the Islamic banking sector.

The Need for a Master Plan

Islamic finance is now taking on a new dimension to meet the changing requirements of consumers and businesses; to participate in a more liberalized and globalised environment and to become increasingly more internationally integrated. The financial system is also operating in an era of change. Indeed,

the national and international financial landscape is being shaped by powerful forces of change, creating an environment of increased uncertainty. However, with clarity of vision on the ultimate goals that the financial system aims to achieve, we can, by our actions and initiatives taken today, help realize our vision of the future.

The Master Plan in essence provides a common vision, and template for countries in developing the Islamic financial services industry. The vision and desired objective will to a large extent depend on the desired aspirations for the economy, expected role of the financial sector in the economy, the stage of development of the economy and the financial sector and the degree of international integration with the rest of the world.

The Master Plan will also serve as a key reference document to guide countries in charting an orderly development of the Islamic financial system. The broad strategies and action plans, with the necessary milestones that need to be pursued over the medium to long term to develop an Islamic financial system can then be identified. Within the defined parameters, countries have distinct options in determining the best course of action to achieve the envisaged country vision. Experiences of other member countries can be compiled to serve as references.

It needs to be recognized however, while the Plan provides the strategic direction, the implementation needs to be managed with flexibility. The approach for the implementation of the action plans outlined in a Master Plan needs to be done in an iterative manner, taking into account the potential for change that may occur in both the domestic and external environment.

The Master Plan will also identify the building blocks of the various parts of the financial sector that need to be put in place to provide the foundation on which further progress can be built. The Financial Master Plan thus provides the sequencing of priorities and identifies the key financial infrastructure that needs to be put in place before advancing forward. In some areas, the implementation can be simultaneous, while in others a more direct route can be taken to enable a more rapid pace of development.

In designing and formulating the Master Plan, consideration needs to be given to the diversity of the member countries of the IDB. The member countries are at various stages of economic development, facing different economic and financial challenges, and with different development priorities. The Master Plan aims to highlight the approaches, templates and building blocks that can be adopted at the different stages in the development of a comprehensive Islamic financial system. A phased-approach would provide the Master Plan with the flexibility to take into account the different stages of economic development of respective countries. While the starting points may differ, countries may adapt the approaches to their requirements and that is commensurate with their stage of development. The Master Plan would allow countries the option to evolve the financial system sequentially, or alternatively the option to accelerate the process of development by providing countries the

opportunity to develop the institutions and supporting infrastructure simultaneously.

Significance of Banking System

At the outset, due attention needs to be given to promoting the development of a comprehensive Islamic financial system, involving the development of the key structural components of the system, comprising the Islamic banking industry, the takaful industry, the non-bank financial institutions, and the Islamic interbank and capital markets. The comprehensiveness of the system will allow for a more balanced allocation of financial and economic resources within an economy and ensure greater diversification of risks within the Islamic financial system. This enhances the resilience and robustness of the Islamic financial system to withstand financial shocks and contributes to the overall stability of the Islamic financial system. The respective components of the Islamic financial system are also highly integrated and inter-dependent. A more diversified Islamic financial infrastructure will contribute to the more efficient functioning of the overall financial system.

Given its roles in the intermediation process and payments system, the Islamic banking system will continue to be at the core of the Islamic financial system. A well functioning and efficient banking system is vital for achieving robust economic performance. As financial intermediaries, banks are entrusted to safeguard their deposits and preserve the efficiency in the manner the funds are mobilised, while vigilantly channeling these savings to productive investments. Given these responsibilities, the banking institutions therefore need to play their role effectively and efficiently to contribute to the overall stability of the financial system, and the growth and development of the economy.

Visioning for the Islamic Banking System

In charting the future development of the Islamic banking system, due consideration would therefore need to be given to the role of the banking system in the economy. The ultimate goal is to **enhance wealth creation, and promote sustainable and balanced economic growth**. The vision is, therefore, to develop a progressive and robust Islamic banking and financial system, rooted in the Islamic core values and principles, that best serves the needs of our economies.

By indicating the destination in the journey, to developing the Islamic banking industry, the Master Plan would provide a road map to drive convergence towards the common vision among countries in the development of an Islamic financial system. While collective efforts can be directed to achieve this common vision, consideration needs to be given to the stage of development of the respective economies. In particular, the expected role that the banking system needs to fulfill can be identified accordingly. This could range from the development of an Islamic banking system to efficiently intermediate funds in the economy, to having in place a sophisticated Islamic banking and financial system that is internationally integrated and that is in itself, an engine of growth.

Pre-requisites of the Islamic Banking System

The development of a vibrant and dynamic Islamic banking system that has a meaningful role in a nation's future economic and social development requires well-defined strategies that focus on two main areas, **building institutional capacity** and the **development of the supporting financial infrastructure**. Allow me to highlight the key areas of the strategies.

The first task is to identify the nature of Islamic banking system that is appropriate for the country - whether to ultimately adopt a dual banking system where Islamic banks and conventional banks offering Islamic banking products operate in parallel with the conventional banking system, or alternatively to adopt a single banking system that fully accords the Shariah injunctions where all the banks are Islamic.

Second, measures need to be in place to ensure that the Islamic banks are well-capitalised and resilient. For Islamic banks that are already in existence, clear criteria need to be specified on the minimum capital size that would enable them to be significant players in the market, be able to gain from economies of scale, have a diversified earnings base and stronger market presence. Such minimum size can either be achieved through organic growth or merger with a partner bank which would bring about the desired outcome in a shorter period of time. Incentives can be provided to induce the banks to consolidate while guidelines on minimum capital size can be imposed to ensure that the banks either merge or undergo a recapitalisation exercise. In the case of countries that are just embarking on the introduction of Islamic banks, this could be achieved by the issue of new Islamic banking licences.

Third, for countries that have a dual banking system, where conventional banks are allowed to offer Islamic banking products, there must be adequate firewalls to ensure absolute separation of banking operations to avoid co-mingling between the Islamic and conventional funds. This is to ensure the integrity of Islamic banking operations and the sanctity of Islamic funds. The firewalls would need to include separate capital funds, cheque clearing systems, clearing accounts with the Central Bank, settlement accounts and reporting systems.

Fourth, regardless of the choice of system, it is important that the stakeholders of the institutions play their role effectively and efficiently to generate improvements in the entity. Of importance, is strong leadership in the management team that has a firm commitment toward performance and capacity enhancements. In addition, investments in the requisite talent and skills is essential to spearhead the development of Islamic financial products.

Fifth, is the need to put in place a comprehensive legal infrastructure. Enactment of an Islamic banking law is an important part of this process. For conventional banks offering Islamic banking products, amendments to the existing banking legislation may be necessary to allow such banks to undertake trade-related activities and

other multi-faceted functions. The investment policy of the Government may need to be reviewed to provide for the issue of Islamic investment instruments to facilitate the liquidity operations of such banking institutions. In addition, a legal fraternity that is competent in both Shariah and civil laws is also important. Finally, in a dual banking system, the tax legislation should accord neutrality in treatment between Islamic and conventional banking products.

Sixth, the development of a comprehensive Shariah framework is a fundamental part of the process. Each institution offering Islamic products will need to establish a Shariah advisory committee to ensure that all Islamic transactions, products and operations are Shariah-compliant. Shariah decisions need to be made transparent to promote greater understanding and the acceptance of such decisions.

Seventh, the importance of a robust and effective regulatory and supervisory framework cannot be over-emphasised. While the financial regulation and supervision of Islamic banking institutions would be similar, the areas such as capital adequacy, the liquidity framework have to take into account the unique risk characteristics of the Islamic banking models that accord the Shariah requirements. Sound corporate governance, transparency, accountability, disclosure, market discipline, risk management and consumer protection are common issues that need to be addressed. In a dual banking system, it is important that opportunities for regulatory arbitrage in banking practices should be eliminated.

Eighth, research and development is important to incorporate core Islamic values into banking products and business models. Research and development, and leveraging on the advances in information and communication technology are also critical in ensuring performance and a more equitable distribution of profits and wealth among all stakeholders. In addition, robust financial models that leverage on the advances in information technology can be used to enhance product development and risk management.

Ninth, the development of the financial market infrastructure is equally important to ensure the sustainability of Islamic banking. The Islamic interbank and foreign exchange markets are integral to the efficient functioning of the Islamic banking system. They facilitate the liquidity operations of Islamic banks and promote financial stability. In addition, they serve as an important transmission channel for the implementation of monetary policy as well as the central bank's role as lender of last resort. The creation of a well-developed Islamic capital market is also important as it provides the users of capital with an alternative and cost-efficient source of longer-term financing, and accords investors with a wider range of financial instruments to suit their different risk profiles. And at the core of any financial system lies an efficient and robust payment system for the clearing and settlement of payments. Other financial infrastructure that provides support to the development of the Islamic banking sector includes the mortgage corporation to undertake the securitisation of house financing, a credit guarantee corporation to

provide guarantee schemes to the SME industry, and a rating agency to rate the Islamic financial instruments and a deposit insurance scheme to provide the necessary safety net for depositors should also be developed. In addition, the auditing, tax and legal firms must have the right talents to provide their services to the Islamic financial institutions. These ancillary institutions must have the ability to provide their services that are in accordance with the Shariah principles.

Tenth, consumer education and awareness about Islamic banking is critical to its success and future development. A consumer education programme needs to be developed to enhance public awareness of the features of Islamic banking products and services.

Translating the Action Plan into Reality

The appropriate Islamic banking system for a country would be largely based on the national agenda of the respective countries, the objectives that the system hopes to achieve and the available resources. For the adoption of a dual banking system, the conventional banks have the option of offering Islamic banking products on a window basis or via full-fledged Islamic branches or an Islamic subsidiary. Conventional bank may also be converted to operate as an Islamic bank. Alternatively, the Islamic banking system may only comprise Islamic banks newly created to operate in parallel with the conventional banking system.

In addition, the government can upgrade existing Islamic savings institutions to Islamic banks; license foreign Islamic banks as a consortium or on joint venture with local banks; or a combination of these options to achieve its objective. Alternatively, a country may wish to adopt a system-wide Islamic banking and finance, a single banking system that fully accords the Shariah framework.

Allow me to take the opportunity to present the Malaysian experience. The development of Islamic banking has transitioned through four distinct phases. The first phase involved the establishment of Islamic financial institutions. In the second phase, conventional banks with the appropriate firewalls in place were permitted to offer Islamic financial products and services. As this window operations achieved a critical mass, the option to transform these operations into Islamic subsidiaries represents the third phase of development. And finally as capacities were enhanced, liberalisation allowed for the international integration of our domestic Islamic banking system in the fourth phase of the development.

The first phase of development of Islamic finance in Malaysia started in 1969 with the establishment of an Islamic savings institution known as the Pilgrim Fund Board, or Tabung Haji, as the first Islamic financial institution in Malaysia. Its objective is to mobilise savings of Muslims intending to perform the pilgrimage and to channel the funds to permissible investments according to the Shariah principles. As awareness of Islamic finance increased, a full-fledged Islamic bank was established in 1983 when Bank Islam, the first Islamic bank was established under the Islamic Banking Act.

The Government Investment Act was also enacted in 1983 to allow for government investment certificates to be issued to facilitate the Bank's liquidity operations. As part of the long term objective of developing a comprehensive Islamic financial system operating side-by-side with the conventional banking system, a year after the establishment of Bank Islam, a takaful or Islamic insurance company was established under the Takaful Act to provide the coverage for Islamic financing.

In the second phase of the development of Islamic banking, conventional banking institutions were permitted to offer Islamic banking products and services on a window basis to leverage on the existing infrastructure, including staff and branch network, and achieve wider market and cost optimisation. This landmark policy was undertaken ten years after the establishment of the full Islamic bank to allow for its greater outreach. The window operations opened the door for the existing conventional banks to participate in the Islamic banking market for both the Muslim and non-Muslim communities.

Under a pilot programme, three conventional banks were initially allowed to offer Islamic banking products and services. Then in early 1994, together with the establishment of the Islamic interbank market, a dual banking system was created. The interbank market is integral to the smooth functioning of the Islamic banking system, and became the first of such models. Concurrently, firewalls between the conventional and Islamic funds were put in place, which included separation of capital funds, cheque clearing system, clearing account with the central bank, settlement account and reporting system. They were also required to establish Islamic banking units to be headed by a senior banker, create an Islamic banking fund with a minimum allocation, and appoint at least a Shariah consultant to advise on the day-to-day operations of the Islamic banking division. In the ensuing years, additional rules and regulations were made to strengthen such operations. Eventually, more players were granted approval to offer Islamic financial products and services. The move enhanced further the vibrancy of the Islamic interbank market.

The efficiency of the Islamic interbank market is enhanced by the Real Time Gross Settlement System (RENTAS) and the Fully Automated System for Tendering (FAST). RENTAS facilitates larger value interbank funds transfers and scriptless securities while FAST facilitates the tendering process for Islamic securities including government securities, commercial papers and private debt securities. Funds are raised to finance long-term infrastructure and development projects through the issuance of Islamic private debt securities.

Recognising the importance of the capital market, Malaysia initiated the development of a private Islamic financial securities market in the early nineties, about six years after the establishment of the Islamic bank, with the issuance of the first Islamic financial instrument. Subsequently, more instruments were issued and these created an investment environment conducive for

investors, including banks. The introduction of the Islamic capital market has reduced the over-dependence on the Islamic banking system for long-term financing and allows Islamic banking institutions to diversify part of the risks emanating from asset and liability mismatches. The existence of the Islamic capital market plays an important role in reducing a potential source of financial vulnerabilities and enhances the robustness and resilience of the Islamic financial system, leading to greater financial stability.

A significant development in the domestic Islamic financial market was the recent issuance of ringgit-denominated Islamic debt securities by two multilateral financial institutions. This has heightened confidence in the Malaysian Islamic financial market. The issuance was made possible following the liberalisation to the foreign exchange administration rules to facilitate multilateral development banks, multilateral financial institutions and multinational corporations to raise ringgit-denominated bonds in the Malaysian capital market.

The Islamic banking system is currently represented by 30 Islamic banking institutions, comprising four Islamic banks and 26 conventional banking institutions, that is, eight commercial banks, four foreign banks, three finance companies, four merchant banks and seven discount houses. The ability of the Islamic banking institutions to arrange and offer products with attractive and innovative features at competitive prices vis-a-viz conventional banking products, has appealed to both Muslim and non-Muslim customers, reflecting the effectiveness and competitiveness of Islamic finance as a form of financial intermediation. The extensive distribution network of Islamic banking institutions, comprising 152 full-fledged Islamic banking branches and 2,065 Islamic banking counters, is also supported by an efficient and secure payment system.

The other institutions which have been established to ensure that the Islamic financial system remain sustainable and robust include the external credit rating agencies such as the Rating Agency Malaysia and Malaysian Rating Corporation Berhad, three more takaful players, five development financial institutions that offer Islamic financial products including a cooperative bank that has fully converted to operating as a full fledged Islamic financial institution and a national mortgage corporation, Cagamas Berhad, all of which offer Islamic financial products.

Malaysia has also adopted legal reform, self-regulation and measures to encourage market-based regulation. New measures have been introduced to further improve the level of governance among banking institutions. In the case of Malaysia, the High Court of Malaysia has dedicated high court judges to preside over litigation on matters relating to Islamic banking and finance. To undertake a holistic legal review, the Central Bank of Malaysia has set up a Law Review Committee to review the common law-based domestic legislations to assimilate the Shariah principles. The aim is to remove any legal impediments and ensure the unhindered and efficient functioning of the Islamic banking and financial system. The Central Bank Act has also been amended to

provide for the establishment of a Shariah Advisory Council at the Central Bank as the sole authority and reference on all Shariah matters pertaining to Islamic banking and finance.

The Islamic financial system today has emerged as an important component of the overall Malaysian financial system that contributes to the growth and development of the Malaysian economy. Since 2000, the domestic Islamic banking industry has been growing at an average rate of 18% per annum in term of assets. As at end-2004, total assets of the Islamic banking sector increased to RM94.6 billion, accounting for 10.5% of the total assets in the banking system. The market share of Islamic deposits and financing also increased to 11.2% and 11.3% respectively.

As the domestic Islamic banking industry progresses into a more advanced stage of development, significant developments are shaping the industry's financial regulatory infrastructure. The developments in the pipe-line include the unique set of prudential regulatory and supervisory standards for Islamic banking operations by the Islamic Financial Services Board, tailor-made set of accounting standards for Islamic financial business by the Malaysian Accounting Standards Board and introduction of the Deposit Insurance Scheme in Malaysia.

Having achieved the critical mass, Bank Negara Malaysia conducted a review in 2003 of the existing 'window' institutional structure of the banks to prepare an enabling structure that can assimilate future developments in the Islamic financial regulatory infrastructure over the longer term and thus strengthen the prudential regulatory and supervisory regime. This represents the third phase in the development of Islamic banking in Malaysia. The new institutional structure known as 'Islamic subsidiary' was introduced in 2004. It is envisaged that greater strategic focus and resources as well as higher autonomy and governance will be accorded to the Islamic banks. To-date, two Islamic subsidiaries of two banking groups have been set up.

Integrating with International Financial System

Another significant milestone in the progress of Islamic banking and finance in the Malaysian banking system in its two decades of development is the issuance of three new Islamic bank licences to Islamic financial institutions from the Middle East. The new entrants with distinctive capabilities and strengths will have the opportunity to bridge the two regions, participate in the growing Islamic banking industry as well as tap new markets in Malaysia and in the region, and promote healthy competition thereby contributing to elevate the industry to new levels of dynamism. In addition, up to 49% foreign interest is permitted in the Islamic subsidiaries. This represents the fourth phase of development of our Islamic banking sector. The pace of the integration process of Islamic finance with the international financial system is dependent on the steps to enhance the robustness and resilience of the domestic Islamic financial system. It will promote increased competitiveness, resilience and

sustainability of the Islamic financial system as a form of financial intermediation. The integration would greatly contribute towards facilitating greater cross border flows in terms of increased trade and investment transactions; thereby, strengthening the global economic and financial inter-linkages. As this international integration process intensifies, it will facilitate greater mobilisation and channelling of resources between countries to productive investments; hence, raising the prospects for more balanced global growth and shared prosperity among the Ummah. This would also allow for more diversification of risks to achieve global stability.

We are witnessing the beginning of this process through greater presence of Islamic banks in the markets of other Muslim and non-Muslim countries as well as ability to raise funds in each others' financial markets, particularly by traditional multilateral institutions. Subscription and trading of Islamic financial instruments by conventional financial institutions is already commonplace, which is undertaken using the existing systems for trading, the existing international exchanges for listing and the existing clearing houses for settlement purposes.

An important initiative in the development of the international Islamic financial architecture is the establishment of the Islamic Financial Services Board (IFSB) in 2002. It was established to promulgate the international regulatory and supervisory standards for Islamic financial institutions worldwide aimed at achieving harmonisation of Islamic banking practices, fostering best practices and securing soundness and stability in Islamic finance. Another initiative to accelerate the integration of Islamic finance was the setting up of the International Islamic Financial Market or IIFM in 2002. The IIFM provides the environment to link all the financial centres around the world that participate in Islamic finance, thereby encouraging active participation by both Islamic and non-Islamic financial institutions in the secondary market for Islamic financial instruments. As the volume increases, it would strengthen the inter-linkages and integration amongst the Islamic financial centres.

While having a Master Plan will provide a shared vision and a common goal, it needs to be recognised that the evolution of an Islamic financial system with all its component parts cannot be achieved within a short period of time. Having the medium and longer term goals outlined however, provides a basis to ensure the short term initiatives will be consistent and coherent with the long term objective. In other words, the construction of the building blocks must move in the right direction. As part of the process, each Islamic banking institution needs to formulate its own strategic plans and short-term action plans within this longer term perspective. With the foundations built and the plans in place, the future is by no means secure. It is only with the combined efforts and perseverance of all the stakeholders that the vision that is being envisaged for the future development of Islamic finance can yield the desired results.

Euro Conference
14 July 2005, Kuala Lumpur

"Expanding ASEAN-EU Economic Links - The Role of The Euro"

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

Bank Negara Malaysia is indeed honoured to co-host this event and would like to especially thank the European Commission for the opportunity. The purpose of this Conference is to bring together recognised experts to discuss the important issues affecting economic, monetary and financial interests in ASEAN and the EU. I believe that the exchange of ideas and views over the next two days would contribute towards an increased understanding of the developments and issues important to our respective regions. Our agenda is for the further strengthening of the close ASEAN-EU partnership that offers mutually reinforcing benefits to both regions. It is our hope that this Conference would serve as a catalyst to promote greater appreciation of the potential for an expanded ASEAN-EU economic relationship - a relationship in which trade and investment flows between our regions can be enhanced.

The ASEAN-EU partnership has developed steadily over time through a number of well-established forums. This has taken place in a global environment in which the world economies and financial systems are increasingly becoming more integrated. As a result, it can be expected that there is increased interdependence, events that take place in one part of the world will have implications on other parts of the world. This is likely to be more pronounced in the ASEAN economies and financial systems, given their openness and their high degree of integration with the global economy and international financial system. As the ASEAN and the EU continues to evolve as strategic partners, new opportunities can also be realized. An enhanced relationship will also contribute towards more effective management of the new challenges in the ever-changing global environment. Indeed, this Conference takes place at an important time when it becomes even more constructive and meaningful for our two regions to strengthen our associations, our inter-linkages and our relationships.

Learning from the experiences of the EU

The unification of Europe on many fronts is a major structural enhancement to the global economic and financial landscape. It is very likely however, that in view of our diversity and different structures and stages of development, the route for the integration process will be significantly different. It can be stated with certainty however, that integration will nevertheless occur. Indeed, the process

has already commenced and it is likely to gain momentum as we advance forward. The motivation being the greater stability it brings and the increased growth potential it generates.

The European experience offers valuable insights in synchronising and pacing the integration process in the ASEAN region. The European path to integration -- based on trade integration, with the removal of restrictions on the movements of goods and all factors of production at the early stages, followed by increased monetary and financial linkages at the subsequent stages - presents ASEAN with an important reference point in our own monetary and financial integration efforts, in particular, in relation to the trade and investment liberalisation initiatives to facilitate greater regional economic integration.

Tremendous Opportunities in ASEAN for the EU

There is certainly much that ASEAN can learn from the EU experience. The EU is now the world's largest integrated market. The EU has become the ASEAN's third largest trading partner. Of its total trade, the trade of the ASEAN 5 (that is, of Indonesia, Malaysia, the Philippines, Thailand and Singapore as a group) with the EU accounted for 12.4% in 2004. Meanwhile, the EU's trade with the ASEAN 5 accounts for 4.5% of the EU's total trade. Against a backdrop of sustained growth and macroeconomic and financial stability in ASEAN, there is significant potential for expanding the trading and investment links between our two regions. Focusing on the areas of complementarities would maximize the mutual benefits to be gained from the strengthened relationship.

The ASEAN Vision Statement is "to create a stable, prosperous and highly competitive ASEAN economic region in which there is a free-flow of goods, services and investments, a freer flow of capital, equitable economic development and reduced poverty and socio-economic disparities" by 2020. The ASEAN economies have for more than a decade now experienced growth that is above the global average. While this growth momentum was interrupted during the Asian currency crisis in 1997 and 1998, the ASEAN economies demonstrated their resilience to resume its strong growth within a short period of a year for many of the affected countries. Opportunities are fast emerging in our region reinforced by the more intensified regional integration that is taking place. In ASEAN, efforts are already being accelerated in the implementation of trade and investment action plans under the ASEAN Free Trade Area (or AFTA, for trade in goods), the ASEAN Framework Agreement on Services (or AFAS, for trade in services) and the ASEAN Investment Area (or AIA, for investment liberalisation).

The initiatives to enhance trade and investment flows to ASEAN have also been accompanied by efforts to strengthen monetary and financial stability. The ASEAN countries have also reinforced efforts in regional financial co-operation, including in the surveillance processes. These has brought together policy makers from the ASEAN ministries of finance and central banks to

constantly engage in discussions on regional and global economic developments which have implications on the ASEAN region. In April this year, the ASEAN countries also doubled the size of its regional financing facility, the ASEAN Swap Arrangement (ASA), from US$1 to US$2 billion. The ASA is a further initiative to maintain regional economic and financial stability through a mechanism that provides short-term liquidity support to member countries facing temporary balance of payments difficulties.

Strengthened Strategic Partnership as a Natural Way Forward

As we advance forward, both the EU and ASEAN through the rebalancing of global growth have the potential to contribute towards alleviating the imbalances in the global landscape.

The process of increased inter-linkages between our two regions has already begun. As a pre-cursor to the establishment of a Free Trade Agreement (FTA), our regions have embarked on the Trans-Regional European Union-ASEAN Trade Initiative in 2003. Work is also already underway to expand trade and investment flows through closer ASEAN-EU co-operation in trade, investment and regulatory issues, among others.

While barriers between our regions will continue to be lowered under a future FTA, it is also important to maintain coherence between liberalisation and economic stability. New areas in specific sectors of mutual interest that would complement the path to greater growth for both regions need to be explored. This would contribute towards reinforcing the sustainability and effectiveness of the ASEAN-EU partnership and, thereby, increase the potential to contribute to global economic stability.

Allow me to conclude my remarks here. Thank you for your participation in this Euro Conference. I hope the sessions ahead will challenge your thinking and present you with many new ideas and perspectives on the prospects of an expanded ASEAN-EU relationship.

Launch of the Asian Bond Fund (ABF) Malaysia Bond Index Fund

18 July 2005, Kuala Lumpur

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

The "Exchange Traded Fund" is a significant and highly successful product of financial innovation that is found in more developed financial markets. First introduced in Canada in the early 1990's, the use of Exchange Traded Funds gathered momentum after the listing of the S&P Depository Receipts Trust Series 1 (also known as "Spiders") on the American Stock Exchange in 1993. Since then, the Exchange Traded Funds have grown tremendously and there are currently a total of 350 such funds on the global exchanges with about USD313 billion in assets, comprising not only stocks and bonds but also currencies and commodities.

It is my great pleasure to be here today at this ceremony of the inaugural listing of the ABF Malaysian Bond Index Fund, the first Exchange Traded Fund in Malaysia. In the EMEAP region, (the East Asia Pacific region) the ABF Malaysian Bond Index Fund represents the second country sub-fund to be launched, following the successful listing of the ABF Hong Kong Bond Index Fund on 21 June 2005. Six other EMEAP country sub-funds will be launched in due course.

The launch of the ABF Malaysian Bond Index Fund today marks another important milestone resulting from EMEAP Central Bank cooperation in the region. It represents the successful implementation of the Asian Bond Fund project to accelerate the development of the domestic bond market and to promote greater integration among the regional bond markets. The listing of the ABF Malaysian Bond Index Fund is thus another major step forward in the development of the Malaysian bond market, and to enhance further its potential to contribute to sustained and balanced growth of our economy.

The bond Exchange Traded Fund is an investment instrument with a low entry cost. It is a highly efficient, transparent and convenient investment tool designed to appeal not only to institutional but also retail investors. With an affordable standard lot size, the bond Exchange Trade Fund provides an avenue for retail investors to have access to the bond market. It thus offers investors an additional investment alternative as well as an opportunity to diversify their investment into more asset classes.

The ABF Malaysian Bond Index Fund comprises investments in Government and Quasi Government securities and tracks an index, which by design is replicable and transparent. The listing of the ABF Malaysian Bond Index Fund today will not only add to the

diversity of listings on Bursa Malaysia but would also pave the way for the increased introduction of other more innovative products in the future. In view of the prevailing dynamic and often volatile financial environment, this development is important to meet the differentiated demands of investors for a broader range of financial products at more competitive prices and through more efficient and convenient channels. The listing of the Exchange Traded Fund on Bursa Malaysia will also raise awareness and generate interest of domestic and international investors in our bond market, thus contributing towards the development of a deeper and broader bond market in Malaysia.

The launch of the Malaysian Bond Exchange Traded Fund would not have been possible without the close cooperation and support of many parties. In particular, I would like to thank the Securities Commission, Bursa Malaysia, the Association of Stock Broking Companies in Malaysia, AmInvest, the fund manager and the market makers for their contributions and commitment in working with the Central Bank to make the listing of the ABF Malaysian Bond Index Fund a reality. The remarkable and strong partnership between the regulators and the industry has been important in resolving significant regulatory as well as operational challenges in order to make the listing of the ABF Malaysian Bond Index Fund possible. Indeed, it represents a strategic cooperation that contributes to improve the overall growth of the financial market.

I would also like to thank AmMerchant Bank, CIMB and Maybank for their participation as the participating dealers. I also wish AmInvest, the fund manager, every success in managing and promoting the Fund.

Calendar of Events
April - June 2005

27 April 2005
The Bank released the 2004 Insurance and Takaful Annual Reports which provide an analysis of the performance and developments of the insurance and takaful industries in 2004.

27 April 2005
The International Bank for Reconstruction and Development (IBRD) became the third issuer of Ringgit-denominated bonds with the launch of the RM760 million Wawasan Bonds, since Multilateral Development Banks and Multinational Corporations were allowed to do so in 2004. This bond issuance was structured in compliance with the Shariah, which would help in further broadening and developing the Islamic domestic capital market in particular, and Malaysia's domestic bond market in general.

24 May 2005
Governor delivered a speech at the Second Islamic Financial Services Board (IFSB) Summit in Qatar, at which she spoke about the importance of securing an enhanced governance framework for Islamic financial institutions.

25 May 2005
The Bank announced that the Malaysian economy remained resilient despite a moderation in global economic activity amidst high oil prices and the continued down-cycle of the global semiconductor industry. Real GDP growth of the Malaysian economy remained favourable and was within expectations, expanding by 5.7% in the first quarter of 2005. During the period under review, Malaysia continued to be one of the strong economic performers in the region.The lack of strong demand pressures allowed monetary policy to continue to remain accommodative to support economic growth. The overnight policy rate (OPR) remained unchanged at 2.70%.

26 May 2005
The Bank announced that to further strengthen the institutional infrastructure of the takaful industry and accelerate the expansion of takaful business, up to four new takaful licences will be issued, and takaful brokers and adjusters will be licensed to increase the level of professionalism and competence of the takaful intermediaries.

30 May 2005
The Bank announced the seventh issuance of Bon Simpanan Merdeka amounting to RM300 million which was issued on 1 June 2005. The bond provides an additional savings instrument to senior

citizens, retired Malaysian Armed Forces personnel, as well as Malaysian citizens who have retired on medical grounds.

9 June 2005

The National Small and Medium Enterprise (SME) Development Council chaired by the Prime Minister, announced further strategies for SME development in the country, which are:-

- New Trade Financing Products for SMEs
- Online Training Portal for SMEs
- Framework for SME Development Planning
- Adoption of Definition for SMEs in Various Sectors for Targeted Development
- Potential for SMEs in the Maintenance of Motorised Vehicles Industry

The Bank is the Secretariat to the SME Development Council.

21 June 2005

Governor delivered a keynote address at the Islamic Banker's Forum organized by the General Council for Islamic Banks and Financial Institutions (CIBAFI) in Putrajaya, in which she said that "investing in the future, in research and development and in the development of talent and expertise will be the differentiating factor that will contribute to the effectiveness, resilience and competitiveness of the Islamic financial services industry."

22 June 2005

Governor delivered a speech at the Seminar on the Ten-Year Master Plan for the Islamic financial services industry, organized by the Islamic Development Bank (IDB) and the Islamic Financial Services Board (IFSB), in which she said that clarity of the vision and the objectives that are to be achieved is important to provide the starting point for the formulation of a Master Plan which defines the blueprint for the future development of Islamic finance. The seminar was held to discuss the key issues and considerations in the formulation of a master plan for the development of Islamic banking and finance in the international arena.

22 - 23 June 2005

The Bank organized an Investors Conference entitled "Malaysia: An Investment Destination" in conjunction with the IDB Annual Meeting, to bring together policy makers, investors and industry players to discuss investment opportunities in Malaysia. In a special address, Governor spoke about the Malaysian economic transformation and the resulting opportunities that Malaysia offers to investors in an evolving global environment. At the end of the conference, Governor launched two benchmark market indices for Malaysia, which are the Citigroup Malaysian Government Bond Index and the Dow Jones-RHB Islamic Malaysia Index.

23 June 2005

The Bank issued commemorative coins in conjunction with the 30th Annual Meeting of the Board of Governors of the Islamic Development Bank which was held on 22-24 June 2005 in Putrajaya. Three types of coins were minted, which are gold, silver and Nordic gold.

24 June 2005

A seminar on Derivatives in Islamic Finance was jointly organized by the Bank and the Financial Market Association of Malaysia, which brings together financial experts to deliberate on the role of derivatives in the development of Islamic finance. In her opening address, Governor said that the challenge facing Islamic finance is to further strengthen the linkages in the respective components of the Islamic financial system, particularly the Islamic financial market.