BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

Pen: 03/05/46 (BN)

EMBARGO: Not for publication or broadcast before 1800 hours on Wednesday, 23 March 2005

PRESS RELEASE

Bank Negara Malaysia Annual Report 2004

Malaysian Economy in 2004

The Malaysian economy expanded by 7.1% in 2004, the fastest growth since 2000. The economy benefited from both stronger external and domestic demand. Notwithstanding some moderation in global growth in the second half of the year, the Malaysian economy remained resilient with the private sector continuing to be the principal driving force of domestic economic expansion. In 2004, the Government progressed further in fiscal consolidation. The overall Federal Government deficit declined to 4.3% of GDP in 2004 (2003: -5.3%). The Government, while consolidating, remained supportive of growth with policies targeted at enhancing the business environment for the economy.

GDP by Expenditure Components (% change)

	2003	2004*p*	2005*f*
Gross Domestic Product	5.3	7.1	5.0 - 6.0
Private Expenditure[1]	5.5	11.1	8.7
Consumption	6.6	10.1	8.5
Investment	0.4	15.8	9.6
Public Expenditure[1]	6.6	1.0	-4.0
Consumption	10.0	6.6	4.5
Investment	3.9	-3.5	-11.6
Net Exports of Goods & Services	20.5	-22.3	43.1
Exports	6.3	15.6	8.1
Imports	5.0	19.8	5.6

[1] Exclude stocks

p Preliminary *f* Forecast

In 2004, GDP growth was led by the private sector, which contributed 6.2 percentage points to the overall economic expansion. Private consumption increased significantly, supported by higher disposable incomes, a rebound in consumer confidence following the events of early 2003 including the Severe Acute Respiratory Syndrome (SARS) outbreak, various tax rebates and low interest rates. Private investment also accelerated during the year as rising demand amidst the high capacity utilisation, higher profitability and favourable financing conditions encouraged investment activity.

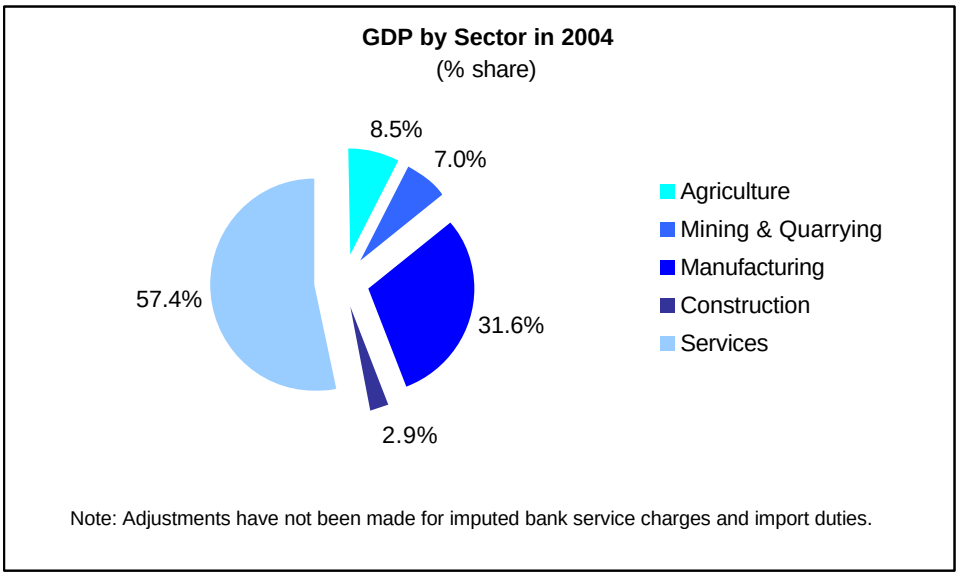
GDP by Kind of Economic Activity (% change)

	2003	2004*p*	2005*f*
Real GDP	5.3	7.1	5.0 - 6.0
(RM billion)	231.7	248.0	260.3
Agriculture	5.7	5.0	3.3
Mining & Quarrying	5.9	4.1	5.0
Manufacturing	8.3	9.8	4.5
Construction	1.9	-1.9	-1.0
Services	4.4	6.7	5.7

p Preliminary

f Forecast

All sectors registered positive growth during the year except construction. In the manufacturing sector, both export- and domestic-oriented industries expanded strongly with high capacity utilisation, in line with the upturn in the global electronics cycle as well as stronger domestic demand. The services sector experienced a stronger expansion, driven mainly by higher consumer spending amidst rising disposable incomes as well as higher tourist arrivals and increased trade-related activities.



The sustained strong expansion of the agriculture sector was driven by higher production of crude palm oil and rubber as well as food-related crops in line with the Government's efforts to revitalize the sector as an important engine of growth. Of significance, prices of agricultural products were significantly higher in 2004, creating a significant multiplier effect on the domestic economy since the sector is the largest employer of rural workforce. Similarly, the mining sector expanded on stronger domestic and external demand amidst higher prices. In the construction sector, activities in the residential and non-residential segments expanded but the overall activity was subdued, due to lower activities in the civil engineering sub-sector following the completion of several large infrastructure projects.

Notwithstanding the strong economic expansion, inflationary pressures were contained. The continued improvement in productivity growth, new capacity expansion

in sectors experiencing strong growth and a more competitive environment were factors that contributed to price stability. Consumer price index (CPI) and core inflation stood at 1.4% and 1% respectively for the year (2003: 1.2% and 0.5% respectively). Labour market conditions remained stable with unemployment rate remaining low at 3.5%.

Inflation and Unemployment (%)

	2003	2004*p*
Inflation		
CPI (2000=100)	1.2	1.4
Core CPI[1]	0.5	1.0
Unemployment	3.6	3.5

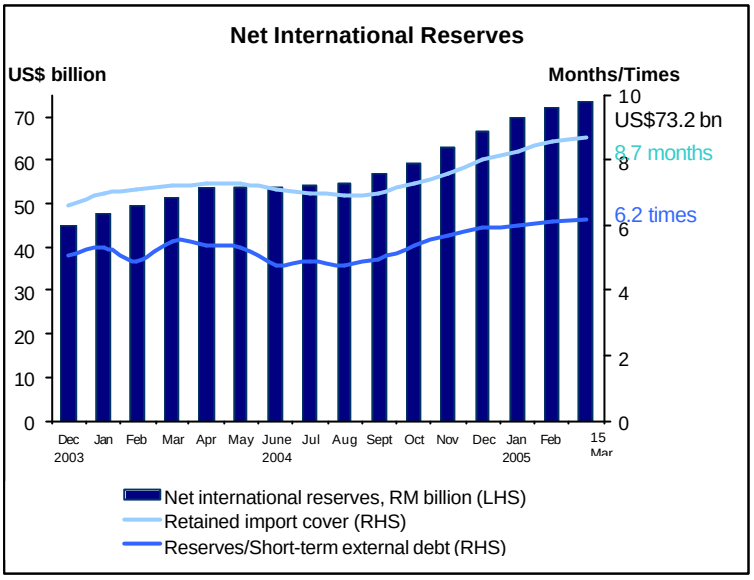
p Preliminary

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

The external sector continued to strengthen considerably, as reflected in the significant increase of international reserves while the external debt position remained manageable. The current account recorded a larger surplus of RM56.6 billion, equivalent to 13.4% of GNP (2003: RM50.8 billon or 13.7% of GNP). Trade surplus continued to remain large at RM81.1 billion (2003: RM81.3 billion) as a result of stronger growth in exports of manufactured goods and higher earnings from the commodity exports. Reflecting robust domestic economic activities, imports grew by 26.3% (2003: 4.4%). There was a significant improvement in the services account deficit due mainly to higher tourism receipts.

The financial account turned around to record a net inflow of RM15.4 billion in 2004 (2003: -RM12.1 billion). The significant shift was attributed mainly to higher inflows of foreign direct investment (FDI) and portfolio funds following stronger economic growth and improved corporate earnings. FDI inflows were channelled mainly into the services, manufacturing and oil and gas sectors. During the year, portfolio investment inflows were significant in both equity and debt securities markets, reflecting positive investor sentiment amid sovereign ratings upgrades and speculation that some regional currencies, including the ringgit had the potential for an upward revaluation. Net

outflows in the other investment reflected both net repayment of external loans by the official sector for the second consecutive year and higher outflows by the private sector.



Reflecting the strong economic fundamentals, the net international reserves registered a significant increase of RM83.1 billion or US$21.9 billion to a record level of RM253.5 billion or US$66.7 billion as at end-2004. The diversified composition of the reserves has yielded a net foreign exchange revaluation gain of RM8 billion or US$2.1 billion, arising mainly from the depreciation of the US dollar against the major currencies during the year. The reserves increased further to RM278.3 billion or US$73.2 billion as at 15 March 2005; sufficient to finance 8.7 months of retained imports and 6.2 times the short-term external debt.

Malaysia's external debt increased moderately to RM197.3 billion (US$51.9 billion), attributable to higher short-term borrowing by the banking sector, which was largely due to hedging activities for trade-related transactions and treasury activities. The share of short-term debt to total debt remained low at 21.8%. Given the prudent debt management policy, Malaysia's share of external debt to GNP improved to 46.6% (2003: 50.2%), while the debt service ratio improved to 4.3% in 2004 (2003: 6.2%).

Macroeconomic Management in 2004

Macroeconomic policy in 2004 was focused on maintaining stability and improving the risk-bearing capacity of the economy. While the Government continued to pursue gradual fiscal consolidation to strengthen its fiscal position, the monetary policy stance remained accommodative to support domestic economic activities. The assessment during the course of the year was that inflation was expected to remain low (2004: 1.4%). The financially sound positions of the corporate, household and banking sectors were instrumental in ensuring the effectiveness of the accommodative monetary policy.

The stable macroeconomic conditions allowed the Central Bank to implement the New Interest Rate Framework on 26 April. The framework represented a change in the implementation mechanism for monetary policy. The change in the conduct of monetary policy was designed to strengthen the monetary policy transmission mechanism and promote more efficient pricing by the financial system. The Overnight Policy Rate (OPR) is designated as the indicator of the monetary policy stance, serving a dual role – as a signalling device to indicate monetary policy stance and a target rate for the Central Bank's day-to-day liquidity operations. To reflect the unchanged monetary stance at its introduction, the OPR was set at the prevailing overnight rate of 2.7% but with flexibility to move within a corridor of ± 25 basis points, supported by a standing facility. Changes in the OPR would be announced through the Monetary Policy Statements (MPS), which are issued at least four times a year in conjunction with the quarterly GDP announcements. The MPS was first introduced in August 2003. The structured and transparent approach to the announcement of monetary policy decisions reduces uncertainty on the policy stance and helps anchor market expectations and thereby, increases the efficacy of monetary policy.

The Bank has also begun to use repo operations as part of its monetary policy instruments to manage liquidity in the banking system. In order to improve the supply of instruments to undertake repo operations, the Bank has developed the Institutional Securities Custodian Programme (ISCAP) to enable lending of securities. Through

ISCAP, the Bank borrows securities, mainly Malaysian Government Securities (MGS), from major investors such as pension funds and insurance companies for its repo operations. The use of repos also enhances the overall functioning of the bond market.

While the prevailing low interest rates were consistent with the overall economic conditions, it was recognised that some segments of society highly dependent on income from deposits could be adversely affected. In this aspect, a special instrument, the Merdeka Savings Bonds, which carries a return of 5%, higher than the fixed deposits, was launched to alleviate the effects of low interest rates on the retirees.

On the exchange rate front, the pegged exchange rate arrangement continues to accord significant benefits to the Malaysian economy by providing predictability and stability for international trade and investment. In 2004, when the US dollar continued its decline, triggering speculation of a change in PR China's pegged regime, there were also some expectations on a review of Malaysia's exchange rate regime. These expectations were partly reflected by the inflows of portfolio funds into the Malaysian equity and debt markets. The Bank has held the view that the exchange rate regime would only be reviewed in the event that the ringgit was headed for a sustained misalignment arising from major structural changes within the international and regional financial system, or if economic fundamentals warranted a change in the system.

In view of the strong fundamentals supporting the economy, the Bank liberalised further the foreign exchange administration rules on 1 April 2004. These include, among others, the simplification of the reporting requirement for the exporters to reduce administrative costs and business processes; higher overnight limits for retention of foreign currency receipts by residents to enhance cash flow management and support value chain expansion in Malaysia; enhancing access to ringgit funding by non-residents for operations in Malaysia; allowing issuance of ringgit denominated bonds by multilateral development banks and foreign multinational corporations; increasing flexibility for domestic fund management institutions to invest abroad and allowing greater flexibility for residents and non-residents to enter into forward foreign exchange

contracts with licensed onshore banks to facilitate efficient risk management of foreign currency exposure. These changes are part of the Bank's continuous efforts to increase efficiency of the regulatory delivery system as well as contributing towards the deepening of the capital market. The impact of past and current changes has been positive. The Asian Development Bank became the first foreign entity to issue ringgit-denominated bonds in November 2004. The issuance was closely followed by the International Finance Corporation, which also became the first multilateral body to issue ringgit bonds that conforms to Islamic principles. In addition, the Bank has committed to participate in the Asian Bond Fund 2 (ABF2) to support steps to broaden and deepen the domestic and regional bond markets, complementing the efforts in the development of the Malaysian capital markets.

As part of the efforts to promote a vibrant financial system through robust payment systems, Bank Negara Malaysia's policy and initiatives were aimed at improving the efficiency and enhancing the safety of payment systems. These include upgrading and improving the accessibility of major payment systems as well as the introduction of the Financial Process Exchange that serves as an internet-based payment system. Efforts to combat fraud and raise consumer confidence on using the electronic channels and instruments such as Internet Banking and credit cards were also given attention.

While the Government expenditure was less expansionary in 2004, efforts were focused towards improving its spending efficiency and delivery system to enhance competitiveness of the private sector. Development expenditure was targeted towards rural communities and over larger number of smaller projects that have significant multiplier effects. In stimulating private sector activity, the Government introduced various tax incentives targeted at specific sectors while concurrently revamping the Government-linked companies (GLCs) in order to transform them into globally competitive corporations in terms of efficiency, shareholder value creation and goal-oriented performance.

Development of SMEs

As part of the efforts to nurture the development of small- and medium-scale enterprises (SMEs) in view of their strong growth potential, Bank Negara Malaysia initiated the establishment of the National SME Development Council in 2004, chaired by the Prime Minister. The Council represents the highest policy-making body and will chart the future direction and strategies for SME development in Malaysia. Bank Negara Malaysia is the Secretariat of the Council. During the year, the Council standardised the definition of SMEs across all sectors of the economy and took initiatives to improve information on SMEs as first steps towards more effective policy formulation and implementation. The Council also initiated programmes to strengthen the enabling infrastructure for SMEs in areas of access to financing, training and human resources development, management as well as marketing. Of significance, the Council approved for the establishment of a SME Development Bank to complement the banking institutions in providing financial and non-financial services to SMEs.

SMEs continued to receive strong financial support from the banking sector in 2004. New loans approved increased during the year by 21.9% to RM31.6 billion and were channelled to more than 92,000 SME accounts. Similarly, loan disbursement to SMEs also expanded strongly by 15.3% to RM100.4 billion. By end-2004, outstanding loans to SMEs expanded by 7.7% and accounted for 40.3% of total outstanding loans to businesses (1998: 27%). In reinforcing the financial assistance to SMEs, Bank Negara Malaysia increased further the allocation of funds to Fund for Small and Medium Industries 2 and the New Entrepreneurs Fund 2, enlarging the five special funds managed by Bank Negara Malaysia to RM8.9 billion.

Performance of the Banking System

The banking sector remained resilient in 2004, with positive developments recorded in all key financial soundness indicators. The risk weighted capital ratio (RWCR) was sustained above 13% throughout the year. Despite several capital rationalisation exercises and strong expansion in assets as a result of higher financing activities, the capital base of the banking system strengthened due to higher profits and

new capital injections by several banking institutions. Asset quality continued to improve with non-performing loans (NPLs) trending downwards to the lowest level since the Asian financial crisis. Net NPL ratio improved to 7.6% based on the 3-month classification. The decline in NPLs was due to lower incidence of new NPLs, as well as sustained recoveries and reclassifications of some NPLs to performing accounts. A number of banking institutions also capitalised on their strong performance to write-off legacy loans that were deemed uncollectible, which partly resulted in RM8.7 billion write offs for the year. Including the value of collateral, the loan loss coverage ratio strengthened further to 165.3% on the 3-month basis and 171.8% on the 6-month basis.

Banking System Health[1]

	2003	2004
Capital		
Core-capital ratio (%)	11.1	10.8
RWCR (%)	13.8	13.8
Net NPL ratio (%)		
6 months	6.8	5.9
3 months	8.9	7.6

[1] Includes Islamic banks.

Gross operating profits of the banking system increased by 3.3% to RM12.6 billion in 2004, driven by higher net income from both interest- and fee-related activities, supported by favourable economic and financial market conditions. Net interest income of commercial banks posted a growth of 13.8%, amidst intense competition that caused interest margins to narrow. Meanwhile, net interest income for finance companies declined by 14.6%, due partly to the technical adjustment following the mergers of five finance companies into the commercial banks. The merchant banks recorded a strong growth in fee income of 7% on account of higher revenue from portfolio management, share placement and syndication activities.

Total loan loss provisions of the banking system increased by 5.4% during the year, attributed mainly to banks adopting stricter provisioning and classification policies

for NPLs to further strengthen their balance sheets. The higher provisions were partially mitigated by an increase of RM0.2 billion in recoveries. Improved gross operating profits combined with higher gains from securities trading and investment activities led to the 16.1% growth in preliminary unaudited pre-tax profits to RM11.8 billion in 2004. Consequently, return on equity and return on assets of the banking system improved to 16.6% and 1.4% respectively.

Banking System[1] Loan Indicators

	2003	2004	Annual Growth (%)
	During the year (RM billion)		
Loan Applications	227.6	273.3	20.1
Loan Approvals	152.8	173.6	13.6
Loan Disbursements	441.6	488.2	10.6
Loan Repayments	430.4	461.6	7.2
Change in loans outstanding[2]	21.6	40.2	8.5

[1] Includes Islamic banks.

[2] The annual growth is for loans outstanding at end-period.

Lending activities of the banking sector remained robust in 2004, supported by strong growth in household consumption and business activities. While demand for loans from the household sector remained strong in 2004, demand for financing by businesses also improved due to larger private investments in new projects and corporate expansion. New loans approved to businesses accounted for 48.9% of total new loans approved by the banking system, whilst loan disbursements to businesses increased by 10.5% in 2004. Of total disbursements of the banking sector, 68.7% were channelled to the business sector.

Of the three agencies established to spearhead the financial sector restructuring during the Asian crisis, only Danaharta remained in operation in 2004. In view of the significant progress in its recovery operations as well as successful redemption of the bonds, Danaharta is on track to unwind its operation in 2005 and close the final chapter of the financial sector restructuring exercise.

Management of the Banking System

The thrust of policy measures in 2004 continued to focus on four broad areas, namely; enhancing the performance and competitiveness of the domestic banking institutions, thus ensuring their readiness for a more liberalised operating environment; preserving financial stability; improving accessibility of key economic sectors to financing; and strengthening the consumer education and protection framework.

Enhancements to the benchmarking exercises were made in 2004 with the spectrum and scope of financial performance and service quality indicators monitored, analysed and shared with the banking institutions expanded to enable them to better measure their performance relative to the industry. In 2004, Bank Negara Malaysia also completed a study to assess customers' expectations and satisfaction on the quality of products and services offered by banking institutions that was shared with the industry to improve the service quality of the sector. To facilitate the domestic banking groups in streamlining their operations, the Banking And Financial Institutions Act 1989 was amended to enable the merger of finance company and commercial bank within the same domestic banking group. In the human intellectual development, the International Centre for Leadership in Finance (ICLIF), established by Bank Negara Malaysia, commenced its Leadership Development Programmes in 2004 to develop leadership talent across the financial industry and the corporate sector, thereby promoting excellence in these institutions.

The introduction of the New Interest Rate Framework and the removal of the ceiling and spread on lending rates gave flexibility to banking institutions to innovate to meet the growing demands for customised and complex financial products. In addition, initiatives were also focused on strengthening the overall infrastructure to promote the development of the SMEs and enhance their accessibility to financing.

In the area of prudential regulations, the focus was on enhancements to existing capital framework, including preparation for the implementation of Basel II and strengthening of corporate governance. The adoption of Basel II in Malaysia will take

place by January 2008 for banking institutions that choose to adopt the Standardised Approach and by January 2010 for those intending to adopt the Internal Ratings Based (IRB) Approach. This is in tandem with the overall policy agenda to promote higher standards of risk management amongst Malaysian banking institutions. The Guidelines on Financial Reporting for Licensed Institutions (GP8) were revised in October 2004 by aligning the disclosure requirements to international standards following the increasing demand for greater public disclosure, transparency and comparability in the information relating to the operations and financial condition of banking institutions.

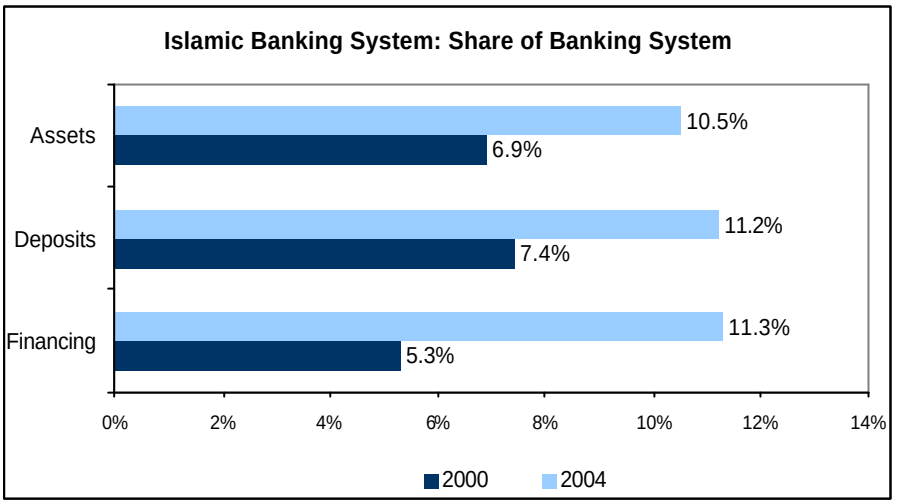
In strengthening consumer protection infrastructure, the Bank introduced the framework on basic banking services aimed at ensuring that the banking public have access to basic banking services at minimal costs. In addition, the Financial Mediation Bureau (FMB) was established to serve as a one-stop centre to resolve disputes against financial service providers regulated by the Bank without entailing lengthy and expensive legal action. Efforts were also focused to enhance financial literacy levels particularly among specific target groups such as students and SMEs as well as enhancing the outreach of key information to a larger segment of the population.

The implementation of the Financial Sector Masterplan (FSMP) remains on track. Another 14 recommendations of the FSMP were fully completed during the year, bringing the total number of fully completed recommendations to 45, which accounts for almost half of the recommendations. Another 28 recommendations are being implemented on a continuous basis.

During the initial phase of the FSMP implementation, efforts were focused on enhancing the capability and capacity of domestic financial institutions. These efforts were continued in 2004 with further institutional development initiatives as well as measures to strengthen the regulatory and supervisory framework, and enhance the consumer education and protection framework. The measures implemented have yielded positive results and strengthened the respective building blocks of the financial sector.

Islamic Financial System

The Islamic financial services industry rapidly transformed into a significant component of the Malaysian financial system, in tandem with the objective envisaged in the FSMP. Islamic assets registered a strong growth of 19% from 2000 to 2004. As at end-2004, Islamic assets stood at RM94.6 billion, accounting for 10.5% of total assets of the banking system.



The Islamic financial services industry entered its third strategic phase of development, underpinned by a stronger financial infrastructure. The issuance of new Islamic banking licences to three leading foreign Islamic financial institutions will intensify competition and innovation, elevating the industry to a higher level of dynamism. The transformation of the "Islamic window" structure of domestic banking groups and foreign banks participating in the Islamic Banking Scheme into an "Islamic subsidiary" grants legal status to the Islamic banking business, according a licence for the operations under the Islamic Banking Act 1983. The flexibility to divest up to 49% of the shares in the Islamic subsidiary to a domestic or foreign partner further enhances the potential of the Islamic subsidiary to tap on the regional and international business opportunities.

A comprehensive and effective Shariah and legal infrastructure has been put in place to support the progressive development of the Islamic financial services industry.

The Shariah Advisory Council of Bank Negara Malaysia has been accorded the legal stature as the sole authoritative body to decide on Shariah matters pertaining to Islamic banking and finance, and serves as the reference point for the court in dispute resolution on Shariah issues in Islamic banking and finance cases. The issuance of guidelines on the Shariah committees at the Islamic financial institutions further strengthens the overall Shariah governance structure. On the legal front, complementing the establishment of a dedicated High Court to adjudicate muamalat cases and an arbitration centre as an alternative dispute resolution mechanism, efforts have been directed to review the relevant laws governing Islamic banking and finance including the tax laws. In this regard, an equitable tax neutrality treatment has been accorded to Islamic financial transactions vis-à-vis similar conventional banking transactions.

In line with the government's strategic direction, initiatives are taken to encourage strong and capable Islamic financial players to venture abroad to tap new markets as well as to explore new growth areas such as wealth management and profit and risk sharing products, which are emerging as rewarding banking activities. Supported by a well-developed and comprehensive Islamic financial system with international inter-linkages, the developments will accelerate the positioning of Malaysia as an attractive Islamic financial hub to the international financial community.

Development Financial Institutions (DFIs)

The financing activities of the development financial institutions (DFIs) increased in 2004, in tandem with the overall growth of the economy. The DFIs complement banking institutions in providing financing to identified priority and strategic sectors of the economy. Total loans outstanding of the DFIs increased by 16.5% or RM5.4 billion (2003: 9.9% or RM2.9 billion) to RM37.7 billion as at end-2004, mainly attributed to lending to the infrastructure sector. Credit enhancement facilities, which include credit insurance and guarantees provided by DFIs, increased by 12.5% to RM4.3 billion as at end-2004.

Policies during the year focused on enhancing further the capacity and the capability of the DFIs. Following the review and assessment conducted by the Bank on the mandated roles and activities of the DFIs, the Government has agreed on the Bank's proposal to realign and rationalise the lending activities and institutional structure of four DFIs. The proposal aims to enhance the strategic focus of these DFIs. In October 2004, the Bank with the assistance of Japan International Cooperation Agency embarked on a project to enhance the capability of the DFIs in providing ancillary services to SMEs. An on-line reporting system was implemented in December 2004 to facilitate the monitoring of DFIs' performance and to assist in policy formulation. Bank Negara Malaysia conducted regular on-site examinations on DFIs to further strengthen their operational soundness.

Outlook for the Malaysian Economy in 2005

For 2005, global economic growth is expected to remain firm at 4% (2004: 4.8%), while world trade is expected to expand by 5.8% (2004: 8.8%). The pace of slowdown in the US and PR China is expected to be modest on the basis that adjustments of the imbalances in these economies would be gradual. In 2005, the US economy is expected to expand by 3.5% after a strong expansion of 4.4% in 2004 while PR China is expected to register a strong growth of 8.5%.

Growth in the East Asian region, excluding Japan, is therefore is expected to expand at a reasonably high rate of 6.3 – 6.5%. Consumption is expected to be sustained by rising incomes and a growing share of the young age group with higher propensity to consume. Domestic demand is also likely to remain resilient given the larger contribution from new sources of growth and increased intra-regional trade.

Given these positive developments, the prospects for the Malaysian economy in 2005 remain sound. Real GDP is expected to expand by 5 - 6% in 2005 (2004: 7.1%). This assessment is based on the assumption of sustained external demand conditions, modest downturn in the global electronics cycle, relatively favourable prices for crude palm oil and crude oil, as well as improved intra-regional trade. Real GDP growth will be

mainly private sector-driven, as the Government remains committed to optimising expenditure to strengthen its fiscal position. High consumer and business confidence, rising incomes and corporate profits as well as an accommodative monetary policy are expected to reinforce robust consumer spending and support the continued upturn in private investment activities.

Economic growth in 2005 is expected to be supported by expansion in all sectors, except construction. Following the strong expansion in 2004, the manufacturing sector is expected to expand at a more moderate pace in tandem with developments in the global semiconductor industry. While the global semiconductor industry is consolidating after reaching a peak in mid-2004, the cyclical downturn is forecast to be modest in view of the strong Asian demand, the rapid inventory adjustments and relatively low inventory levels. Current indicators point to an expected upturn in the global semiconductor cycle in the second half-year. Growth in the services sector is projected to remain firm, reflecting expansion in all sub-sectors. The sector has shifted from depending on a narrow range of activities related to trade and manufacturing to a broader range of activities supported by domestic consumption and growth in new services activities related to tourism and business support services.

The contribution to growth from the agriculture and mining sectors is likely to remain strong, supported by higher production amidst the favourable commodity prices. The construction sector is expected to remain weak due to lower civil engineering activity following the completion of several projects as well as lower public spending on infrastructure projects.

Inflation is expected to edge up in the first half year, reflecting the continuing one-off impact of price adjustments to retail petroleum products as well as higher taxes on cigarettes and tobacco that were implemented in 2004. The impact is expected to be transitory, and inflation is expected to moderate in the second half-year. Given the lack of significant general demand pressures, inflation is projected to average 2.5% in 2005.

Core inflation is projected at 1.8%. The unemployment rate is expected to remain low against the favourable economic environment.

The balance of payments is expected to remain strong in 2005, with the surplus in current account remaining large and continued inflows of FDI. The trade surplus is expected to remain large as the moderation in exports would be offset by slower growth in imports while the services deficit is expected to improve further with continuing growth in tourist arrivals and export of computer and information services. In the financial account, FDI inflows are expected to remain significant and channelled to higher value-added activities in the manufacturing and services sectors. FDI inflows into the services sector are likely to be mainly in the areas of wholesale and retail trade and business and support services. In the oil and gas sector, recent discoveries of new oil fields in Malaysia are likely to spur greater investment in exploration and extraction activities. Overseas investment by Malaysian companies is expected to remain large as companies seek to gain access to new markets and natural resources to diversify their earnings and to support domestic activities through vertical integration.

Economic, Monetary and Financial Management in 2005

The focus of policies in 2005 is on sustaining the momentum of economic growth and improving the long-term competitiveness and resilience of the Malaysian economy. The fiscal deficit for the year is projected to decline gradually to 3.8% of GDP (2004: -4.3%). Overall government spending would be reduced in a prudent manner without creating any adverse impact on the economy. Given the ample liquidity in the financial system, the bulk of government financing would continue to be raised from the domestic market with no risk of crowding out private sector financing.

While inflation may increase in the early part of the year due to changes in prices of administered goods, tax-dependent goods and some pass-through from imported goods, these factors are expected to be temporary and inflation is expected to moderate in the second half of 2005 once these effects wear off. Monetary policy will remain responsive to both external and internal conditions, ensuring that pre-emptive measures

can be taken if there are significant shifts in growth and inflation prospects that warrant a change in monetary stance.

The thrust of financial sector policy for 2005 will continue to be directed at enhancing the competitiveness of the financial sector, as well as promoting a sound and robust financial system that is able to support economic growth and development. Emphasis would also continue to be accorded to further strengthen the consumer education and protection framework. Ensuring continuous access to financing for all segments of the economy will remain as an important endeavour in 2005. There will also be deregulation and liberalisation with progressive infusion of competition into the financial sector. Policy measures will continue to focus on enhancing the capacity and capability of domestic banking institutions. It is anticipated that more mergers of commercial bank and finance company entities within a domestic banking group will take place in 2005. Initiatives would continue to be focused on advancing risk management practices and strengthening corporate governance framework.

In an environment where banking group structures are becoming more complex, the Bank will strengthen its prudential regulation and surveillance over diversified financial conglomerates by finalising the Framework for Consolidated Supervision of Financial Conglomerates in 2005. The framework would provide regulators with a holistic approach in assessing the financial health of conglomerates. Extensive discussions with the industry will take place on the implementation of Basel II in 2008 to ensure that the necessary skills and expertise are harnessed and appropriate infrastructure are in place to facilitate a smooth transition to Basel II. Risk management of banking institutions will be further improved with the inclusion of market risk in the Risk Weighted Capital Ratio framework beginning April 2005.

Efforts will be directed to encourage banking institutions to introduce new lending models and products to cater to the financing needs of SMEs, agriculture and agro-based industries as well as microenterprises, which are potential growth areas. As part of the efforts to strengthen the consumer protection infrastructure, a deposit insurance

system is being established. The framework on the system has been finalised and the Deposit Insurance Bill will be tabled at the Parliament in 2005.

For the payment systems, the focus is to further improve the efficiency and effectiveness of electronic payment systems, particularly cheque clearing and remittance systems. The Bank will facilitate an industry-wide collaboration to further improve the security measures in Internet Banking transactions, enhance cross-border payments mechanisms, promote payment related standards to facilitate payment referencing and improve efficiency and services of the Interbank Giro system to increase its usage. The consumer protection framework in payment related services, such as measures to promote responsible lending in credit cards and to avoid over-indebtedness, would also be enhanced.

In the Islamic banking sector, policies in 2005 will continue to focus on further strengthening the Islamic banking system as an integral component of the Malaysian financial system. The policy thrust will centre on the enhancement of institutional structure, the regulatory and prudential framework, legal and Shariah framework, product and market development, human capital development and consumer education. To meet the increasing manpower requirement, the initiative is also being taken to enhance the intellectual capital and expertise with the objective of creating a larger pool of experts and high calibre professionals in Islamic banking and finance.

Efforts will be directed at strengthening the provisioning and liquidity framework to enhance efficient regulatory structure as well as to meet the specific requirements of the Islamic banking operations. The development of an Islamic reference rate to act as a benchmark for the pricing of Islamic banking products will be pursued. To promote sound development of the legal infrastructure, the review of the Islamic Banking Act 1983 will be undertaken on a comprehensive and in-depth basis to keep pace with market development. Transparency in banking practices will also be an important focus for the year as part of the efforts to increase customer awareness and agenda.

For DFIs, the policy will continue to emphasise on enhancing the capacity and capability of DFIs in providing financial and non-financial support to the targeted sectors of the economy. In particular, the rationalisation in the sector aims to ensure the institutions effectively and efficiently provide financial and advisory support to key sectors. To complement the capacity building strategies, initiatives are pursued to strengthen the financial and operational soundness, corporate governance standard and risk management practices of the DFIs.

With effect from 1 April 2005, Bank Negara Malaysia will relax further the foreign exchange administration rules as part of its ongoing initiatives towards reducing cost of doing business, improving regulatory delivery system and encouraging better risk management activities by residents and non-residents as well as promoting the development and stability of domestic financial markets. As such, rules on hedging by residents and non-residents are relaxed further to improve better risk management while limit imposed on domestic credit facilities by non-resident controlled companies is abolished. Rules on retention of foreign currency funds, investment abroad and foreign currency credit facilities by residents are also liberalised to enhance management of funds and provide opportunities for diversification abroad.

Bank Negara Malaysia's Audited Annual Accounts for 2004

Bank Negara Malaysia's financial position in 2004 has been examined and certified by the Auditor General. Total assets of the Central Bank rose to RM284.9 billion as at end-2004 (end-2003: RM200.8 billion). The major increase in assets was attributed to an increase in international reserves. Bank Negara Malaysia's international reserves increased to RM253.5 billion (US$66.7 billion) as at end-2004. The Central Bank registered a net profit of RM2.1 billion for the financial year ended 31 December 2004 and declared a dividend of RM1.2 billion to the Government for the year 2004.

Bank Negara Malaysia
23 March 2005