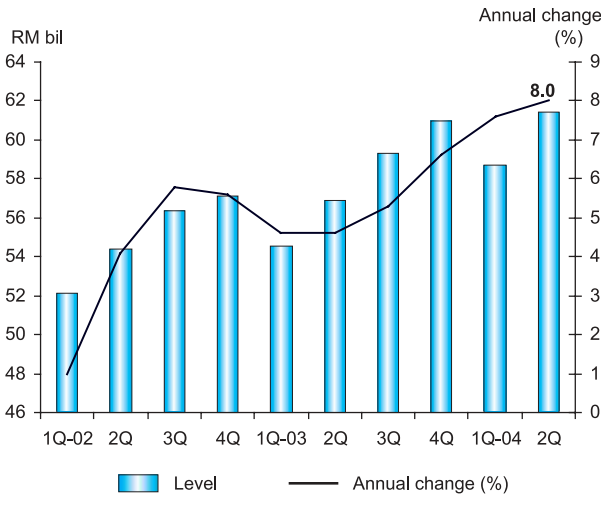
Economic and Financial Developments in the Malaysian Economy in the Second Quarter of 2004

OVERVIEW

Growth momentum strengthens further

The Malaysian economy strengthened further, with growth in real GDP increasing at a faster pace of 8% in the second quarter of 2004, from 7.6% in the first quarter. Private sector aggregate demand was more robust and reinforced by buoyant growth in external demand. Stronger domestic demand emanated largely from stronger household consumption and the strengthening of private investment activities, as the public sector continued to consolidate. The private sector continued to be the main growth driver, contributing significantly to real GDP growth.

Stronger real GDP growth in 2Q 2004



Growth continued to be broad-based, led by the manufacturing and services sectors. The strong growth in the manufacturing sector was sustained at 12.1% (1Q 2004: 12.7%). Both the export- and domestic-oriented industries registered strong expansion of 18.3% and 8% respectively. In the export-oriented industries, higher growth was recorded in the electronics, chemical products and rubber products industries. Strong expansion was seen in the electronics industry, particularly from high demand for consumer electronics and communication devices. This had positive spillover effects on growth in the chemical products industry, particularly resins and plastic products, which supply inputs to the electronics industry. Meanwhile, sustained external demand for gloves continued to support the expansion in the rubber products industry. In the domestic-oriented industries, robust growth in domestic demand underpinned the expansion in the food products, fabricated metal products, and iron and steel as well as transport equipment industries.

Value-added growth in the services sector was faster at 7.4% (1Q 2004: 6.2%), with both final and intermediate services recording strong growth of 7.3% and 7.6% respectively (1Q 2004: 5.4% and 7.4% respectively). Growth in the final services segment, particularly the wholesale and retail trade, hotels and restaurants sub-sector, was stronger due partly to the combined effects from a strong pick-up in tourism and domestic consumption activities, and partly due to the low base effect. In the intermediate services segment, the transport, storage and

communication sub-sector continued to record strong growth due to increased trade- and travel-related activities and strong expansion in the telecommunication industry. Higher bank lending and insurance activities as well as property transactions provided further support to the services sector.

Growth in the agriculture sector was sustained at 3.2%, due mainly to higher expansion in rubber and other agriculture activities such as livestock and fisheries, which more than offset the decline in palm oil production owing to lower yields. Meanwhile, growth in the mining sector moderated to 1.1%, due mainly to the decline in crude oil production following the temporary shutdown of several oil and gas fields and plants for maintenance purposes.

The construction sector contracted by 1.7% due to lower civil engineering activity which was partly mitigated by higher activities in the residential and non-residential segments. Low interest rates, higher incomes amidst favourable commodity prices and a stable job market supported the demand for residential property. Expansion in the non-residential sub-sector was due mainly to improved business sentiment and investment activity, which underpinned demand in the retail shop and office segments. Overall, construction activity is expected to benefit from the additional allocation of RM10 billion for development expenditure under the Eighth Malaysia Plan.

Despite the ongoing fiscal consolidation, domestic demand growth strengthened further in the second quarter of 2004, with further expansion of private sector activities. Growth in private consumption expanded strongly by 11.4% (1Q 2004: 8.4%), supported by higher disposable income, improved consumer confidence, low inflation and interest rates, as well as stable employment conditions. In line with the Government's commitment to fiscal consolidation, public consumption increased moderately, while public investment continued to be pared down. Gross fixed capital formation continued to register a strong growth of 3.5% (1Q 2004: 3.5%), underpinned entirely by stronger private investment activities as Federal Government's development expenditure continued to decline. The fiscal deficit was 4.5% of GDP in the second quarter.

Inflation remained low at 1.2% in the second quarter. New capacity expansion in sectors experiencing strong growth, stable labour market conditions and increasing competitive pressures, contributed towards reining in price pressures in a strong growth environment.

Balance of payments developments also reflected more buoyant economic conditions. The large trade surplus narrowed slightly (2Q 2004: RM18.1 billion; 1Q 2004: RM19.3 billion), as imports of intermediate and capital goods rose in response to strengthening investment and capacity expansion. The growth in gross exports by 22% was due to stronger expansion in exports of manufactured goods and commodities. The trend of stronger growth in manufactured exports reflected strong external demand for electronics and electrical products, chemicals and rubber products. With the exception of

palm oil and saw log exports, which were driven entirely by strong prices, higher exports of other major agriculture commodities and minerals were due to both higher prices and volume, especially for rubber, crude oil and LNG.

The stronger expansion in gross imports by 32.1% reflected mainly stronger consumption demand and private investment, rising manufacturing production as well as increased outsourcing for lower cost inputs from regional countries for the electrical and electronics industry. In tandem with strong external demand for electronic products, imports of intermediate goods recorded a strong growth of 31.6%. Consonant with the upward trend in private investment growth, imports of capital goods expanded further by 27.6%. Increase in capital imports is reflective of capacity expansion in the manufacturing and oil and gas sectors. Imports of consumption goods increased rapidly by 26.5%, reflecting stronger growth in domestic consumption. Another significant development during the quarter was the strong growth in imports for re-exports which involved packing and assembling activities at distribution parks located in the free commercial zones at the major ports. Excluding re-exports, imports rose by 30%.

In the financial account, FDI inflows remained high and were channeled mainly to the services sector, specifically the business and support services and wholesale and retail trade sub-sectors. The manufacturing sector, especially the electrical and electronics, petroleum-related and chemical-related manufacturing activities, as well as the oil and gas sector continued to attract FDI inflows.

With the continued high repatriation of export earnings, sustained inflows of FDI and portfolio funds and drawdown of external loans, net international reserves increased by US$2.5 billion to US$53.9 billion at end-June 2004. The level of international reserves rose further to US$54.4 billion as at 14 August 2004, sufficient to finance 7.2 months of retained imports and is 5 times the short-term external debt.

Strong expansion of financing to the private sector

Ample liquidity and prevailing low interest rates effectively supported the financing needs of the private sector. Gross private sector financing through the banking system and the capital market increased significantly by 8.7% in the second quarter of 2004. Loan disbursement by the banking system increased further by 14.8% during the quarter (1Q 2004: 14.4%), with higher lending to both the business and household sectors. Higher loan disbursements to businesses remained broad based, with financing channeled mainly to the manufacturing sector, the wholesale and retail trade, restaurants and hotels sector, and the finance, insurance and business services sector. Lending to small and medium enterprises (SMEs) continued to increase in the second quarter. A total of RM8.3 billion was approved to 22,161 SME accounts (1Q 2004: RM5.7 billion to 18,703 accounts). While lending to households was sustained during the quarter, the gross NPL ratio of the sector remained manageable at 7.6% at end-June 2004 (7.9% at end-March).

A significant development in the second quarter was the introduction of the new interest rate framework on 26 April 2004. The Overnight Policy Rate (OPR) replaced the 3-month intervention rate as the indicator of monetary policy stance. The OPR was set at the prevailing overnight interbank rate of 2.70%, reflecting that the new interest rate framework did not represent a change in monetary policy stance. Transition to the new framework was smooth as market participants responded within expectations. The daily weighted average of the overnight interbank rate moved within a narrow range in the period 26 April -19 August, averaging 2.70%.

The new interest rate framework also included removal of the base lending rate (BLR) formula. Each banking institution now announces their own BLR based on their cost structure and business strategies. With only one bank lowering its BLR, the average BLR of the commercial banks was slightly lower at 5.98%, while the average BLR of finance companies remained unchanged at 6.90% as at 15 August 2004. The average lending rates (ALRs) of the commercial banks and finance companies continued to decline during the quarter and as at end-July 2004, stood at 6.00% and 8.69% respectively (6.10% and 8.95% respectively as at end-March). This reflected the larger proportion of new loans priced at lower rates.

Sound Banking System

The banking system remained sound with the risk-weighted capital ratio (RWCR) at 13.8% as at end-June 2004. The profitability of the banking system improved further with a pre-tax profit of RM3.3 billion, as higher incomes and lower provisions offset the increase in operating costs during the quarter. The annualized return on average assets and equity of the banking system was higher at 1.6% and 18.7% respectively. The net NPL ratio based on 6-month classification declined further to 6.2% at end-June 2004 due to higher loan recoveries and reclassifications as well as lower incidences of new NPLs.

Expectations of sustained growth in the second half-year

Overall, the global economic performance in the first half of 2004 has surpassed expectations. GDP growth was higher than expected in the first half-year and more balanced across regions. While indicators point towards some moderation in global growth in the second half-year, global growth is still expected to remain strong, supported by continued growth in consumer and investment demand. In the United States, positive labour market conditions suggest more self-sustaining growth in the second-half year. In Asia, recovery in Japan is ongoing while growth in P.R. China remains high. Continued expansion in intra-regional trade and domestic demand as well as favourable outlook for the global economy would continue to support growth in the regional economies.

Global economic conditions have become more challenging with higher energy prices, rising interest rates and some slowdown in the major economies. Our

assessment is that the impact of these risks on global growth in 2004 would be modest. While oil prices are expected to remain high due to concerns on supply disruption, the global economy has a greater capacity to manage high energy costs in view of better economic conditions, higher incomes, improvements in job prospects and more efficient use of energy. Gradual interest rate increases towards a more neutral stance would ensure growth is sustained in the United States. Current indications of a soft landing to be achieved in P.R. China and sustained domestic demand in regional economies will be positive for Malaysia. Overall, the balance of risks indicates sustainable growth prospects going forward.

This favourable external environment is expected to further reinforce domestic demand growth in Malaysia. Forward-looking indicators continue to support strong and sustainable growth in the domestic economy. The Index of Leading Indicators also suggests that the economy will further expand in the second half-year. In the manufacturing sector, demand for semiconductors is expected to remain strong given the increasing application of chips in a broad range of applications, particularly those which are consumer driven. Malaysia is positioned to benefit from growth in consumer electronics and communications, due to the large share of Malaysia's electronics output used in these applications. In the services sector, expansion in the wholesale and retail trade, hotels and restaurants, and transportation and communication sub-sectors is likely to continue with strong tourist arrivals and expanding trade and manufacturing-related services.

Improved consumer and business confidence, favourable commodity prices, stable employment conditions and rising incomes are expected to support further growth in private consumption and investment. Given the high savings, rising incomes and liquidity in the banking system, there is potential for higher consumption to support growth without undermining financing of private investment from domestic sources. Favourable financing conditions and improving corporate profitability as well as sustained growth in external demand will support private investment in the second half-year. In the business sector, the forward-looking indicators, loan applications and approvals by the banking system were significantly higher in the second quarter. Overall, growth would continue to be private sector driven with ongoing consolidation by the public sector.

The underlying fundamentals of the Malaysian economy continue to remain strong with low inflation, stable labour market conditions, sound and strong banking system and rising external reserves. Expanding capacity and increasing competitiveness of the domestic economy will contain price pressures in the strong growth environment. Monetary policy will, therefore, remain accommodative. The supportive external environment and conducive domestic conditions ensure that growth is likely to remain strong in the second half of the year. Following the strong growth performance of 7.8% for the first half-year, growth for the year as a whole is expected to surpass earlier estimates.

DEVELOPMENTS IN THE SECOND QUARTER OF 2004

International Economic Environment

Sustained GDP growth across all regions

Global economic activity remained firm in the second quarter, sustained by strong growth in the United States (US), continued economic revival in Japan and Europe and broad-based expansion in Asia. Meanwhile, growth in the People's Republic of China (P. R. China) moderated but continued to remain at a high level.

In the **US**, growth remained strong albeit at a less rapid pace in the second quarter, supported by higher business investment and inventory rebuilding while efficiency in energy usage mitigated the adverse impact of higher energy prices on consumer spending. Against the backdrop of sustained economic expansion and upturn in inflationary expectations, the Federal Reserve increased rates in June, signalling a less accommodative stance in monetary policy. In the **euro area**, despite weak consumer spending and uncertainty on structural reforms, economic recovery continued to be sustained by fiscal stimulus and strong export performance. Growth in the **United Kingdom** registered its fastest expansion in nearly four years, spurred by high consumer spending and strong activity in the services, manufacturing and housing sectors. In **Japan**, despite some moderation in capital spending, stronger export demand continued to drive economic recovery, while growth from domestic sources remained encouraging with private consumption improving in response to more stable labour market conditions.

Industrial Countries: Real GDP growth

	2003		2004		Key contributing factors for 2Q growth
	1Q	2Q	1Q	2Q	
	Annual change (%)				
US[1]	1.9[r]	4.1[r]	4.5[r]	3.0	Investment and inventory re-building,while consumer spending moderated
UK	2.1	2.0	3.4	3.7	Strong activity in manufacturing and services sectors. Fastest expansion in nearly four years.
Germany	0.4	-0.3	0.4	0.5	Strong export performance despite cautious consumer spending as well as uncertain sentiment on structural reforms.
Japan[1]	2.2	3.5[r]	6.6	1.7	Despite moderation in capital spending, rising exports coupled with improvements in private consumption continued to underpin the recovery.

1 annualised basis
r revision
Source: National authorities

In the **Asian** region, growth momentum remained robust during the second quarter, mainly supported by resilient export performance of the technology sector and strong intra-regional trade.

Regional Countries: Real GDP growth

	2003		2004		Key contributing factors for 2Q growth
	Q1	Q2	Q1	Q2	
	Annual change (%)				
P.R. China	9.9	7.9	9.8	9.6	Continued broad-based growth with strong retail sales and exports.
Singapore	1.7	-3.9	7.5	12.5	Double-digit expansion in the manufacturing and services sector.
Korea	3.7	2.2	5.3	5.5	Expansion in investment and robust exports.
Indonesia	5.5	4.8	5.0	4.3	Supported by private consumption and investment.

Source: National authorities

Inflation in the region trended markedly upwards during the quarter, mainly reflecting higher food prices and persistently high global crude oil prices. In Indonesia and Philippines, weaknesses in domestic currencies added further inflationary pressures. Meanwhile in Hong Kong China, deflationary trends further dissipated, following rising consumer spending, robust growth in the tourism industry and declining unemployment rate. Despite rising inflationary pressures, interest rates in the region remained relatively low, in view of ample liquidity in most of the regional economies.

Meanwhile, global equity market strength abated during the second quarter due to concerns on corporate earnings and interest rate hikes while Asian equity markets were also affected by concerns about a possible sharp slowdown in P.R. China.

Going forward, global economic expansion is expected to moderate somewhat as further momentum would likely be influenced by the extent to which consumption in industrialised countries would be affected by continued high oil prices. Meanwhile, growth prospects in the Asian region are expected to remain favourable amid buoyant intra-regional trade and strong underlying domestic demand in most regional economies.

Developments in the Malaysian Economy

Growth driven mainly by strong expansion in manufacturing and services sectors

In the second quarter, growth was sustained in most sectors, with robust expansion in the manufacturing and services sectors. The robust performance of the manufacturing sector was in line with strong demand from the current global electronics up-cycle and improved global economy. The buoyant growth in trade as well as transhipment and telecommunication activities also drove growth in the services sector, especially the transportation, storage and communication sub-sector, while the final services sub-sector grew at a higher pace, supported by strong consumption and tourism activities, thus contributing to the higher growth of 7.4% in the services sector. Besides the underlying strengths across the sub-sectors, growth in the services sector was also partly due to the low base in the corresponding period of 2003 due to SARS. While growth in the agriculture sector was sustained, the mining sector grew at a more moderate pace. The construction sector contracted during the quarter due to weaker civil engineering activity.

Quarterly GDP by Kind of Economic Activity at 1987 Prices

	2003		2004		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
Agriculture	10.7	7.8	3.2	3.2	3.2
Mining	13.0	8.7	5.8	1.1	3.5
Manufacturing	6.5	6.2	12.7	12.1	12.3
Construction	1.4	1.3	0.6	-1.7	-0.6
Services	3.4	4.1	6.2	7.4	6.8
Real GDP (Ann. Chg.)	**4.6**	**4.6**	**7.6**	**8.0**	**7.8**
Real GDP (Preceding Chg.)	**4.3**	**-1.8**	**-3.7**	**4.6**	**-0.1**

Source: Department of Statistics, Malaysia

Continued strong growth in the manufacturing sector

The strong growth in the **manufacturing sector** was sustained with

value added expanding by 12.1% (1Q: 12.7%). Continued robust expansion was seen in both the export-oriented industries (18.3%; 1Q: 19.3%), and domestic-oriented industries (8%; 1Q: 7.6%). Despite high investment in capacity expansion, the overall capacity utilisation rate remained high at 81%, with export- and domestic-oriented industries operating at 85% and 74% respectively.

Capacity Utilisation in the Manufacturing Sector



The sustained strong expansion in the export-oriented industries was underpinned mainly by higher production in the electronics (32.7%), chemical products (18.7%) and rubber products (20.9%) industries. In particular, the electronics industry was supported by the strong global demand for semiconductors, due mainly to the wider applications of chips in communications and consumer electronics, such as DVD players and digital cameras. This also had a spillover effect on the chemicals industry especially industries which supply inputs for electrical and electronics products such as plastics and resins. As a result, output in the chemicals industry expanded further by 18.7% (1Q: 16.9%; growth exceeding 20% in 2003).

The rubber products industry continued to record strong growth, supported by sustained export demand for rubber products such as examination and surgical gloves for the food, medical and industrial users. Meanwhile, the domestic-oriented industries strengthened further, due largely to strong growth in the food products (8.4%), fabricated metals (27.8%), and iron and steel (9.2%) as well as transport equipment industries (8%). Higher output in the food products industry largely reflected stronger private consumption, whereas the underlying strength of the metals industry arose from strong external demand from the US and Thailand. The transport equipment industry expanded moderately, benefiting from higher domestic sales of passenger vehicles.

Performance in the Manufacturing Sector

	2003		2004		
	2Q	1H	1Q	2Q	1H
	Annual Change (%)				
Value Added (Constant Price)	**6.5**	**6.2**	**12.7**	**12.1**	**12.3**
Overall Production	**8.2**	**7.9**	**16.5**	**15.9**	**16.2**
Export-oriented industries	**10.0**	**9.0**	**19.3**	**18.3**	**18.8**
of which :					
- Electronics	7.0	7.8	34.1	32.7	33.4
- Electrical	-7.6	-6.1	-6.9	-7.1	-7.0
- Textiles & wearing apparel	2.3	1.6	-10.8	-6.6	-8.7
- Chemicals and chemical products	23.8	20.0	16.9	18.7	17.8
- Off-estate processing	27.3	16.0	3.3	-6.0	-1.8
- Rubber products	14.3	11.9	24.1	20.9	22.5
- Wood and wood products [1]	-0.4	1.8	13.9	20.8	17.4
Domestic-oriented industries	**3.3**	**4.8**	**7.6**	**8.0**	**7.8**
of which :					
- Transport equipment	-13.5	-10.1	0.8	8.0	4.4
- Fabricated metal products	7.9	6.0	35.4	27.8	31.2
- Iron & steel and non-ferrous metal	0.8	8.1	6.2	9.2	7.7
- Non-metallic mineral products	11.4	10.7	-1.2	-8.9	-5.2
- Petroleum products	17.5	9.3	-1.9	-5.5	-3.7
- Food	7.3	6.4	7.3	8.4	7.9
Total Manufactured Exports	**7.2**	**6.9**	**17.3**	**20.5**	**19.0**
- Electronics and electrical products	3.9	2.3	14.9	17.8	16.4
- Wood and wood products	5.5	9.1	28.2	32.3	30.3
- Furniture & parts	5.1	6.9	14.5	14.8	14.6
- Textiles, clothing & footwear	3.3	5.7	16.6	19.2	17.9
- Optical & scientific equipment	15.8	17.4	11.4	33.2	22.8
- Chemical and chemical products	22.6	27.7	25.2	27.2	26.3
- Petroleum products	23.8	44.5	20.0	25.3	22.4

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

Robust growth in the services sector

The **services sector** continued on its upward trend to record a robust growth of 7.4% in the second quarter, underpinned by higher trade-related activities, strong consumer spending and rapid growth in tourist arrivals. Of significance, the wholesale and retail trade, hotels and restaurants sub-sector recorded the strongest growth of 10% due partly to the low base effect arising from SARS during the corresponding quarter of the previous year (2Q 2003: -2.3%). The sub-sector also benefited from higher domestic demand and significant increase in international tourist arrivals (2Q 2004: 1.3 million tourists per month; 2Q 2003: 0.6 million per month). Of importance, there has been a discernable increase in high spending tourists mainly from P. R. China, Chinese Taipei and West Asia. On the domestic front, spending by Malaysians remained strong, as reflected in the increase in credit card spending and consumption credit disbursed during the quarter.

Meanwhile, the transport, storage and communication sub-sector continued to register a strong growth, due to increased trade- and travel-related activities as well as continued robust expansion in the telecommunications industry. The growing subscriber base and higher usage of mobile data services amidst launches of new products and inter-operability facility for Multimedia Messaging Services (MMS) supported growth in this sub-sector during the quarter.

Performance in the Services Sector (Value Added)

	2003		2004		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
Intermediate Services	**4.9**	**4.8**	**7.4**	**7.6**	**7.5**
Transport, storage & communication	4.0	4.6	7.8	8.4	8.1
Finance, insurance, real estate & business services	5.4	5.0	7.2	7.1	7.1
Final Services	**2.3**	**3.5**	**5.4**	**7.3**	**6.4**
Electricity, gas & water	5.2	6.3	8.8	8.8	8.8
Wholesale & retail trade, hotel & restaurants	-2.3	0.4	5.8	10.0	7.9
Government services	10.3	9.2	3.2	2.2	2.7
Other services	2.2	2.9	5.1	6.4	5.7
Total Services	**3.4**	**4.1**	**6.2**	**7.4**	**6.8**

Source: Department of Statistics, Malaysia

Selected Quarterly Indicators in the Services Sector

	2003		2004		
Indicators	2Q	1H	1Q	2Q	1H
	Levels				
Electricity Production Index	244.4	237.7	248.9	266.8	257.9
KLSE CI (end-period)	692.0	692.0	901.9	819.9	819.9
MIER Consumer Sentiment Index	106.9	-	117.5	112.4	-
MIER Retail Survey Index	96.3	-	119.3	137.0	-
MIER Hotel Operators Index	81.3	-	134.5	142.5	-
MIER Travel Agencies Index	73.3	-	124.9	119.7	-
	Annual change (%)				
Tourist arrivals	-51.6	-30.7	38.4	127.4	71.7
Import of consumption goods	-2.7	0.8	14.3	26.5	20.5
Consumption credit disbursed	1.9	2.5	13.0	17.5	15.3
Total passenger traffic in all airports in Malaysia	-15.9	-3.7	10.9	44.6	26.0
Total TEUs handled [1]	18.9	19.0	15.8	17.8	16.9
Total loan outstanding (end-period)	4.2	4.2	5.7	6.2	6.2
Total property transactions (value)	-1.3	0.9	30.1	52.7	41.8

[1] For PTP and Port Klang
Source: Various sources

Growth in the finance, insurance, real estate and business services sub-sector remained strong. Bank lending rose further while sustained strong growth in the insurance industry was driven mainly by increased interest in investment-linked insurance products. The sub-sector was also supported

by increased activities in the stock market and higher property transactions to take advantage of relevant incentives under the May 2003 Economic Package, which ended in May 2004.

Continued contribution from the primary commodity sector

Growth in the agriculture sector was sustained at 3.2% due mainly to robust growth in rubber production as well as other agriculture activities, which more than offset the decline in crude palm oil production. Rubber, together with other agriculture account for about 65% of total value add of the agriculture sector. Meanwhile, the mining sector registered a moderate growth during the quarter, due mainly to lower crude oil production.

In the **agriculture sector,** production of rubber continued to expand strongly by 32.9% due to active tapping by smallholders, who account for almost 95% of total national rubber output, amidst remunerative prices averaging 476 sen per kilogram (2Q 2003: 325 sen per kg). The sector was further supported by strong growth in the other agriculture activities, namely livestock, fisheries and miscellaneous agriculture such as vegetables and fruits. In contrast, production of crude palm oil declined by 5.9% during the quarter (1Q 2004: +2.5%) due to lower yields. The average yield in terms of fresh fruit bunches during the quarter was significantly lower at 4.3 tonnes per mature hectare vis-à-vis 4.96 tonnes in the corresponding quarter in 2003. Thus, the monthly average production of crude palm oil was lower at 1.09 million tonnes (2Q 2003: 1.16 million tonnes).

Performance of the Agriculture Sector

	2003		2004		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
Value Added (at 1987 prices)	**10.7**	**7.8**	**3.2**	**3.2**	**3.2**
Production [1]					
Of which:					
Crude palm oil	27.4	14.2	2.5	-5.9	-2.3
Crude palm kernel oil	29.0	11.3	3.8	-10.9	-4.4
Rubber	9.7	12.7	23.4	32.9	27.6
Saw logs	10.6	12.6	-20.1	-16.4	-18.0
Cocoa beans	-14.4	2.8	-33.5	-8.5	-22.5
Exports (RM million)	**33.7**	**37.4**	**13.8**	**11.4**	**12.5**
Of which:					
Palm oil					
('000 tonnes)	15.6	12.7	5.1	-12.7	-4.8
(RM/tonne)	24.8	32.1	6.5	16.9	11.9
(RM million)	44.4	48.9	11.9	2.1	6.6
Palm kernel oil					
('000 tonnes)	7.1	-15.6	35.4	20.4	26.9
(RM/tonne)	17.2	33.2	27.8	61.6	45.6
(RM million)	25.6	12.4	73.1	94.5	84.8
Rubber					
('000 tonnes)	-5.4	3.0	23.4	12.1	17.7
(Sen/kilogramme)	51.0	53.6	36.5	35.9	36.1
(RM million)	42.9	58.2	68.4	52.3	60.1
Sawn timber					
('000 cu.metres)	57.7	34.0	2.8	-28.0	-16.7
(RM/cu.metre)	-34.0	-21.1	-9.6	31.9	12.9
(RM million)	4.0	5.8	-7.1	-5.0	-6.0
Saw logs					
('000 cu.metres)	24.2	19.0	-13.5	-11.0	-12.1
(RM/cu.metre)	9.1	15.1	1.0	19.6	11.3
(RM million)	35.5	36.9	-12.6	6.4	-2.1
Cocoa beans					
('000 tonnes)	-38.0	-11.8	-76.0	-8.3	-42.3
(RM/tonne)	37.2	43.3	-20.3	-12.9	-14.0
(RM million)	-14.9	26.4	-80.9	-20.1	-50.4

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

Lower production of crude oil led to a moderate growth in the **mining sector** of 1.1%. Production of crude oil (including condensates) declined marginally by 0.2%, to average 738,400 barrels per day (bpd) during the quarter (1Q 2004: 772,800 bpd; 2Q 2003: 740,100 bpd), due to the temporary shutdown of several oil and gas fields and plants for maintenance purposes. While the scheduled maintenance had also affected natural gas production, total output was still 4% higher than in the corresponding period of the previous year. The growth was due to expansion in output from the MLNG Tiga plant

amidst the higher demand for LNG, particularly from major buyers, namely Korea, Chinese Taipei and Japan.

Performance of the Mining Sector

	2003		2004		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
Value Added (at 1987 prices)	**13.0**	**8.7**	**5.8**	**1.1**	**3.5**
Production					
Of which:					
Crude oil and condensates ('000 barrels)	11.8	6.9	8.0	-0.2	3.8
Natural gas (net) (million standard cubic feet)	17.7	12.8	2.3	4.0	3.1
Exports (RM million)	**34.9**	**45.0**	**15.4**	**43.6**	**28.2**
Of which:					
Crude oil					
('000 tonnes)	1.7	3.9	4.1	4.5	4.3
(US$/barrel)	16.0	36.8	4.4	33.6	17.7
(RM million)	18.0	42.1	8.6	39.6	22.7
Liquefied natural gas					
('000 tonnes)	40.6	19.2	18.3	34.1	25.5
(RM/tonne)	26.3	31.5	-2.3	1.5	-0.5
(RM million)	77.6	56.8	15.6	36.0	24.8

Weaker construction sector

The **construction sector** contracted by 1.7% in the second quarter of 2004 (1Q 2004: 0.6%) due to lower civil engineering activity which was partly mitigated by higher activities in the residential and non-residential sub-sectors. Demand for houses continued to remain firm, supported by the low interest rates and stable labour market conditions. Expansion in the non-residential sub-sector was underpinned by activity in the retail shop and office segments. Overall, construction activity is expected to benefit from the additional allocation of RM10 billion for development expenditure under the Eighth Malaysia Plan.

Construction Indicators

	2003		2004		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
New sales and advertising permits	-16.7	-20.1	42.0	0.7	18.1
Housing approvals	0.8	-13.6	48.5	-15.2	8.2
Production of construction-related materials	6.5	9.5	2.2	-0.9	0.6
Loans approved for construction	-44.3	-20.8	-36.8	30.7	-6.7
Imports of construction materials & mineral products	-20.1	-9.2	14.5	42.8*	25.6**

* *April-May'04*
** *Jan-May'04*
Source: Ministry of Housing and Local Government and Department of Statistics, Malaysia

Domestic demand strengthened further, led by the private sector

Amidst further consolidation in the public sector, the private sector was the main engine of growth, contributing significantly to GDP growth. Robust expansion of private sector led domestic demand growth in the second quarter of 2004 to outperform the first quarter (8.1%; 1Q 2004: 7%). Evidence of robust growth in household consumption and stronger private investment activities indicates that the sustainability and quality of growth have improved significantly.

GDP by Expenditure Components (at Constant 1987 prices)

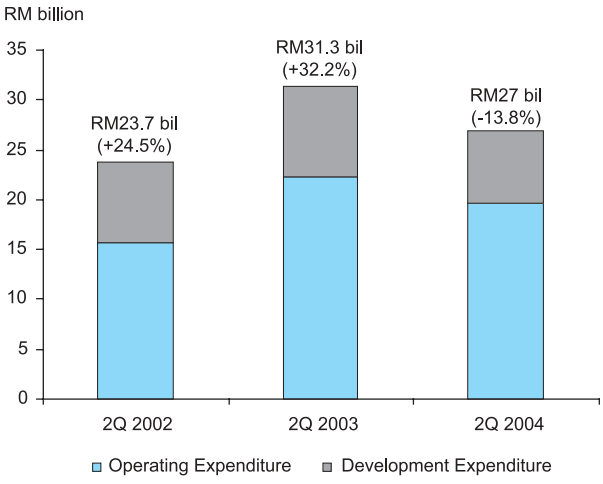
	2003		2004		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
Aggregate Domestic Demand (excluding stocks)	4.0	5.3	7.0	8.1	7.6
Consumption	5.9	6.9	8.6	10.4	9.5
Private sector	*5.0*	*5.5*	*8.4*	*11.4*	*9.9*
Public sector	*8.9*	*12.6*	*9.2*	*7.1*	*8.0*
Gross Fixed Capital Formation	0.4	2.0	3.5	3.5	3.5
Exports of Goods and Services	4.4	4.9	15.6	19.3	17.5
Imports of Goods and Services	-0.5	1.1	19.4	25.3	22.4
GDP	**4.6**	**4.7**	**7.6**	**8.0**	**7.8**

Source: Department of Statistics, Malaysia

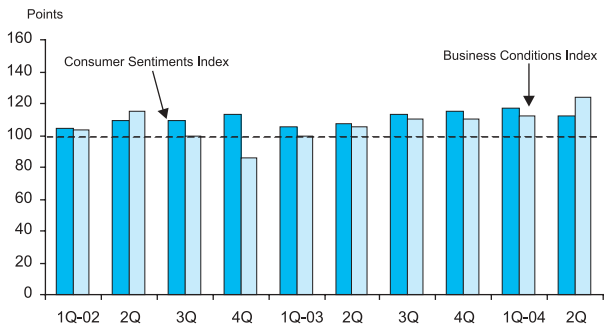
Private consumption remained robust in the second quarter, with the pace of expansion strengthening to 11.4% (1Q 2004: 8.4%). Consumer confidence strengthened with sustained increase in disposable incomes, improving business conditions, high export earnings, continued firm commodity prices as well as the low interest rate environment. As a result, strong expansion was recorded in all major consumption indicators such as credit card spending, imports of consumption goods, loans approved to households and consumption credit and loans disbursed to wholesale, retail, restaurants and hotels. Sales of passenger cars were also markedly higher during the quarter, after declining for six consecutive quarters. Meanwhile, **public consumption** increased moderately in the second quarter, with sustained expenditure on supplies and services as well as defence.

The **gross fixed capital formation** continued to record a strong growth of 3.5% (1Q 2004: 3.5%) in the second quarter, driven entirely by stronger private investment activities as Federal Government development expenditure continued to decline. Private investment expanded strongly during the quarter, as reflected mainly in the continued investment in machinery and equipment and capacity expansion due to continued improvement in business confidence, high capacity utilisation as well as favourable financing conditions and improving corporate profitability. In addition, domestic investment was also supported by the sustained inflow of foreign direct investment. The higher investment during the quarter was reflected across most sectors, particularly in manufacturing, oil and gas and telecommunication sectors. The improved business confidence during the quarter was reflected in the higher Business Condition Index, which rose significantly by 12.1 points to 124.1 points (1Q 2004: 112), indicating strong local and export orders and sales performance as well as higher capacity utilisation rate. In addition, major indicators such as sales of commercial vehicles, imports

Lower Federal Government Spending



Business confidence strengthened further

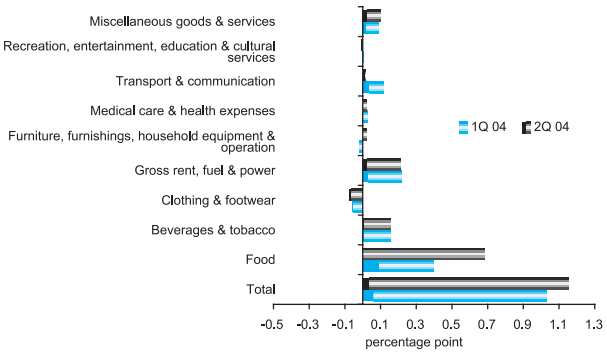


of capital goods, loans approved and loans disbursed to businesses and manufacturing increased significantly, pointing towards stronger growth in business activity. Meanwhile, the bulk of the Federal Government development expenditure continued to be disbursed to transportation infrastructure, education, health and agriculture.

Inflation continued to remain low

While growth remained robust in the second quarter, **inflation**, as measured by the change in the Consumer Price Index (CPI, 2000=100), remained low at 1.2% (1% in 1Q 2004). Higher price increases for food taken away from home, perishable food items and transport services following the increase in the price of petrol on 1 May 2004, were partially offset by the lower prices in communication. For the first six months of 2004, the average annual inflation rate stood at 1% (1.1% in the first six months of 2003).

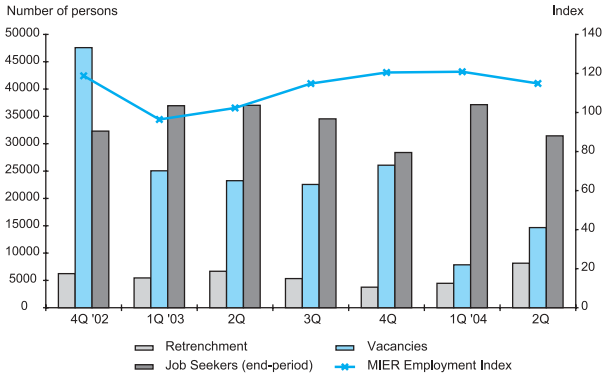
Contribution to Inflation



Labour market conditions remained stable

Labour market conditions remained stable. Stronger GDP performance was reflected in higher growth in productivity and a decline in unplaced job seekers. In the manufacturing sector, in the second quarter, labour productivity, as measured by real sales value of products per employee rose by 19.5%, exceeding the 3.9% increase in real wage per employee. Reflecting the prevailing stable conditions, vacancies as reported to the authorities during the quarter outpaced retrenchment (14,660 positions and 8,155 persons respectively).

Stable Labour Market Conditions

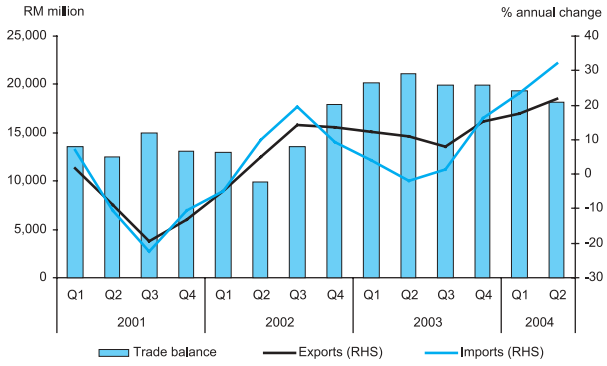


Narrowing of trade balance as exports matched by strong imports

The **trade surplus** narrowed, but remained large at RM18.1 billion (1Q 2004: RM19.3 billion). Consistent with more robust economic activities, gross imports expanded at a stronger pace of 32.1%. Gross exports continued to expand at a strong pace of 22%.

Growth in **gross exports** strengthened further in the second quarter of 2004, reflecting higher exports of manufactured goods and commodities. The stronger export performance reflected mainly increases in export volume (15.8%), while export prices rose moderately due mainly to higher prices of crude oil, rubber and palm oil. The increase in export volume was mainly in manufacturing, as well as LNG, crude oil and rubber.

Trade balance



Amidst favourable developments in the global economy, **manufacturing exports** strengthened further by 20.5% (1Q: 17.3%), driven by strong external demand for electronics and electrical products, chemical products and rubber products. Exports of electronic products benefited largely from higher demand from the Asia-Pacific region and the US, whilst the higher exports of chemical products, rubber products and metal products are a reflection of broad-based demand from the regional countries, EU and the US. Higher exports were also recorded for other items such as petroleum products, paper and pulp products, textiles and clothing and food products. While the export prices of non-resource based industries continued to decline, this has been more than offset by rising export prices for the resource-based industries. Overall, export prices registered a marginal increase (0.8%; 1Q: -1.1%), while volume of manufactured exports expanded further by 20.5% (1Q: 19.5%).

Exports of **agriculture commodities** expanded further by 11.4% during the quarter (1Q 2004: 13.8%), attributable to increased palm oil and rubber exports. Palm oil exports (RM5.1 billion) were driven entirely by strong prices, which averaged RM1,835 per tonne (1Q 2004: RM1,766 per tonne). Meanwhile, export volume of palm oil declined by 12.7%, following lower offtake by Malaysia's major buyers, namely India and Pakistan, given better domestic harvests of oilseeds during the period. Reflecting continued supply constraints in the global edible oils markets, particularly soybean oil (palm oil's closest substitute), against the favourable demand, prices of palm oil remained relatively high during the quarter. Similarly, exports of rubber remained strong during the quarter, growing by 52.3%, driven by both strong increases in prices (35.9%) and export volume (12.1%). Demand for rubber, especially from major buyers including P.R. China, Middle East and the European Union which together accounted for two-thirds of Malaysia's total rubber exports, grew strongly during the quarter, increasing between 6 to 42%.

Exports of **minerals** increased at a rapid pace of 43.6% due mainly to higher crude oil prices. During the quarter, export prices of Malaysian crude oil rose by 33.6% to

US$37.86 per barrel (1Q 2004: US$34.06 per barrel), in line with developments in the international crude oil markets. Meanwhile, LNG exports increased by 36% on higher purchases by three major buyers, namely Korea, Chinese Taipei and Japan, in line with their improved economic performance.

Trade Account

	2003		2004		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
Gross Exports	**11.1**	**11.7**	**17.4**	**22.0**	**19.7**
Manufacturing	*7.2*	*6.9*	*17.3*	*20.5*	*19.0*
Agriculture	*33.7*	*37.4*	*13.8*	*11.4*	*12.5*
Minerals	*34.9*	*45.0*	*15.4*	*43.6*	*28.2*
Gross Imports	**-2.0**	**0.8**	**23.5**	**32.1**	**27.9**
Capital goods	*-10.8*	*-5.0*	*23.2*	*27.6*	*25.4*
Intermediate goods	*-0.4*	*1.4*	*22.5*	*31.6*	*27.2*
Consumption goods	*-2.7*	*0.8*	*14.3*	*26.5*	*20.5*
Trade balance (RM bil)	**21.2**	**41.4**	**19.3**	**18.1**	**37.5**

Source: Department of Statistics, Malaysia

The market share of exports to the region remained high in the second quarter at 44%. Export growth to the East Asian region outpaced that of the major industrial countries, driven mainly by the expansion in exports of electrical and electronics products, LNG and palm oil. Exports to P. R. China and Hong Kong China grew by 30.2% and 25.3%, thus expanding Malaysia's export share to these markets to 6.8% and 6.4%, respectively. Supported by higher exports of electrical and electronic products, chemical and wood products, exports to the United States grew by 15.5% to account for a higher market share of 19.3%. Meanwhile, in tandem with rising economic activity, exports to the EU countries and Japan grew by 14.8% and 18.6% respectively.

Gross imports grew by 32.1% to RM99.8 billion. Higher import growth reflected sustained growth in production and exports of electrical and electronic products, stronger domestic demand and investment activities. Imports of **intermediate goods**, which are mainly inputs for manufactured exports, grew by 31.6%. Higher imports during the quarter also reflected increased sourcing for low cost inputs from Thailand, Indonesia, and P.R. China. Components, including imports of industrial supplies and parts and accessories of capital goods (except transport equipment), which are inputs for the electrical and electronics industry, recorded significant increases. Reflecting the strong growth in

Malaysia: Direction of exports

	2003		2004			2003		2004			2003		2004		
	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	**19.7**	**36.9**	**19.3**	**22.8**	**42.0**	**20.4**	**19.6**	**17.8**	**19.3**	**18.6**	**4.4**	**3.9**	**11.9**	**15.5**	**13.8**
European Union	**12.0**	**23.4**	**13.3**	**13.7**	**27.0**	**12.4**	**12.4**	**12.3**	**11.7**	**12.0**	**16.0**	**11.5**	**16.0**	**14.8**	**15.4**
Selected ASEAN countries [1]	**23.9**	**46.9**	**26.9**	**28.8**	**55.7**	**24.7**	**24.9**	**25.0**	**24.4**	**24.7**	**4.1**	**6.2**	**17.3**	**20.3**	**18.8**
North East Asia	**18.2**	**36.0**	**21.9**	**23.1**	**45.0**	**18.8**	**19.1**	**20.3**	**19.6**	**19.9**	**17.7**	**22.2**	**23.0**	**26.8**	**24.9**
People's Republic of China	*6.2*	*11.5*	*7.2*	*8.1*	*15.3*	*6.4*	*6.1*	*6.7*	*6.8*	*6.8*	*32.8*	*30.2*	*34.9*	*30.2*	*32.4*
Hong Kong China	*6.0*	*11.9*	*6.4*	*7.5*	*14.0*	*6.2*	*6.3*	*6.0*	*6.4*	*6.2*	*31.6*	*39.4*	*8.6*	*25.3*	*17.0*
Chinese Taipei	*3.5*	*6.8*	*3.6*	*3.8*	*7.4*	*3.6*	*3.6*	*3.3*	*3.3*	*3.3*	*-3.6*	*3.3*	*6.4*	*11.2*	*8.8*
Korea	*2.6*	*5.8*	*4.7*	*3.7*	*8.4*	*2.7*	*3.1*	*4.4*	*3.1*	*3.7*	*-3.4*	*5.4*	*47.5*	*43.1*	*45.5*
India	**2.5**	**4.7**	**2.7**	**2.7**	**5.4**	**2.6**	**2.5**	**2.5**	**2.3**	**2.4**	**45.2**	**59.1**	**21.3**	**10.9**	**15.8**
Total exports	**96.7**	**188.7**	**107.9**	**118.0**	**225.9**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**11.1**	**11.7**	**17.4**	**22.0**	**19.7**

1 Include Singapore, Thailand, Indonesia, Philippines, Brunei Darussalam and Viet Nam
Source: Department of Statistics, Malaysia

private consumption, imports for the food and beverages processing industry grew by 109.5%.

Consonant with strong expansion in private investment, imports of **capital goods** expanded at a robust rate of 27.6%. Capital imports, excluding lumpy import items, grew by 26.2%. The increase is reflective of capacity expansion in the manufacturing and oil and gas sectors. Investment in machinery and equipment and capacity expansion in the manufacturing sector strengthened as business sentiment improved while capacity utilisation was at near full capacity. Reflecting the increase in exploration activities in the oil and gas industry, imports of construction and mining equipment recorded significant growth. In line with higher disposable incomes, imports of **consumption goods** increased by 26.5%. Higher imports of consumption goods reflected imports of food and beverages for household consumption and consumer goods. Another significant development during the quarter was the strong growth in imports for re-exports arising from packing and assembling activities at distribution parks located in the free commercial zones at the major ports.

Malaysia: Imports by Economic Function: Broad Economic Categories (BEC) Classification

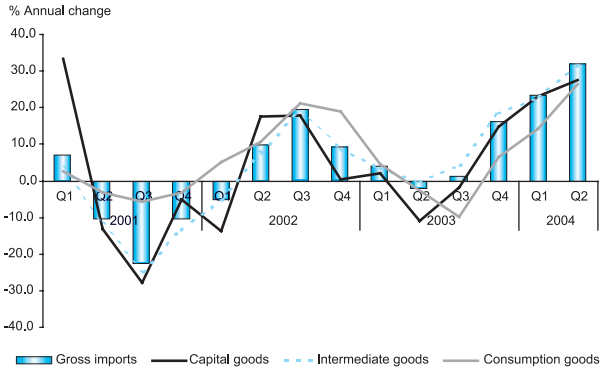
	2003		2004		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
CAPITAL GOODS	**-10.8**	**-5.0**	**23.2**	**27.6**	**25.4**
Capital goods (except transport equipment)	9.7	9.0	12.9	25.5	19.4
Transport equipment	-84.2	-74.2	205.1	79.9	150.8
INTERMEDIATE GOODS	**-0.4**	**1.4**	**22.5**	**31.6**	**27.2**
Food and beverages, mainly for industry	13.4	26.2	31.8	109.5	64.8
Industrial supplies, n.e.s.	-3.2	2.5	25.1	47.7	36.4
Fuel and lubricants	44.1	37.6	-2.1	23.3	11.4
Parts and accessories of capital goods (except transport equipment)	-0.4	-1.3	23.2	20.4	21.7
Parts and accessories of transport equipment	-40.5	-24.8	24.6	74.3	46.4
CONSUMPTION GOODS	**-2.7**	**0.8**	**14.3**	**26.5**	**20.5**
Food and beverages, mainly for household consumption	-13.1	-8.3	19.8	37.8	28.5
Transport equipment, non-industrial	108.9	106.8	-8.5	15.2	3.4
Consumer goods,n.e.s.	2.5	5.4	11.5	20.6	16.2
Durables	*22.4*	*22.4*	*8.1*	*14.5*	*11.4*
Semi-durables	*-15.3*	*-12.6*	*15.8*	*22.2*	*19.2*
Non-durables	*10.8*	*14.4*	*10.2*	*22.5*	*16.6*
DUAL USE GOODS	**17.0**	**22.6**	**22.2**	**26.3**	**24.2**
OTHERS	**-1.5**	**0.9**	**7.5**	**5.2**	**6.3**
RETAINED IMPORTS	**-1.9**	**0.8**	**21.7**	**30.0**	**26.0**
RE-EXPORTS	**-8.4**	**0.9**	**89.6**	**107.7**	**99.0**
GROSS IMPORTS	**-2.0**	**0.8**	**23.5**	**32.1**	**27.9**

Source: Department of Statistics, Malaysia and Bank Negara Malaysia.

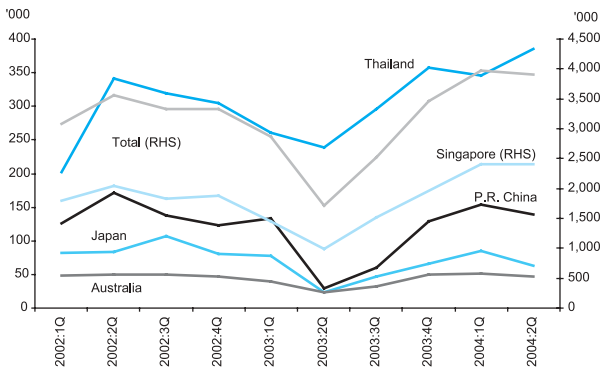
Sustained high level of tourist arrivals

Tourist arrivals were sustained at a high level of 3.9 million tourists (1Q 2004: 4 million) for the quarter. A significant share of arrivals was from Singapore, Thailand,

Import growth



Quarterly Tourist Arrivals



Indonesia and P. R. China, in line with the increase in flights and strong economic performance of regional countries. Tourists from ASEAN countries accounted for 80.3% of tourist arrivals. Reflecting the increased number of flights to East Malaysia and promotional campaigns, tourist arrivals from UK, Australia and US remained high.

Sustained inflows of FDI, while portfolio investment moderated

On a cash basis, gross inflows of **foreign direct investment (FDI)** were sustained in the second quarter (RM3.6 billion; 1Q 2004: RM3.5 billion). The FDI inflows were channelled mainly to the services sector, specifically the business and support services and wholesale and retail trade sub-sectors. Investment flows into the manufacturing sector remained large, particularly in the petroleum-related, electrical and electronics and chemicals activities, as well as the oil and gas sector. After adjustments for outflows due mainly to loan repayment to related companies, FDI recorded a higher net inflow of RM0.9 billion (1Q 2004: RM0.6 billion).

Gross outflows for **overseas investment** were higher at RM2.7 billion (1Q 2004: RM2.1 billion). The bulk of the investments was effected by companies in the services sector, particularly business and support services and wholesale and retail trade. There were also significant investments by the oil and gas sector, followed by companies in the manufacturing sector, particularly from the petroleum-related and electrical and electronics industries. Overseas investment, after adjusting for inflows from repayment of inter-company loans from abroad, recorded a higher net outflow of RM1.7 billion (1Q 2004: - RM1.1 billion).

Net inflows of **portfolio investment** moderated but remained large at RM3 billion (1Q 2004: RM16.3 billion), in line with consolidation in the KLSE and several regional bourses during the quarter.

External debt remains within prudential limits

Malaysia's total external debt increased to RM193.7 billion or US$51 billion as at end-June 2004, equivalent to 49.3% of GNP. The **medium and long-term external debt** increased by 1.4% to RM152.1 billion or US$40 billion (1Q 2004: RM150 billion), reflecting net borrowing of external loans by the non-financial public enterprises (NFPEs). The NFPEs, which recorded eight consecutive quarters of net repayments, reversed to register a net drawdown of RM3.3 billion during the quarter. The higher gross drawdown of external loans by the NFPEs, particularly from the transportation sector, was mainly for capital expenditure. Meanwhile, both the Federal Government and the private sector registered net repayments of external loans during the quarter.

The total **short-term external debt** rose to RM41.7 billion or US$11 billion (1Q 2004: RM35.2 billion), attributable to an increase in short-term debt of the banking sector, due mainly to their hedging activities in relation to trade-related transactions and money market operations involving regional treasury activities. This development is

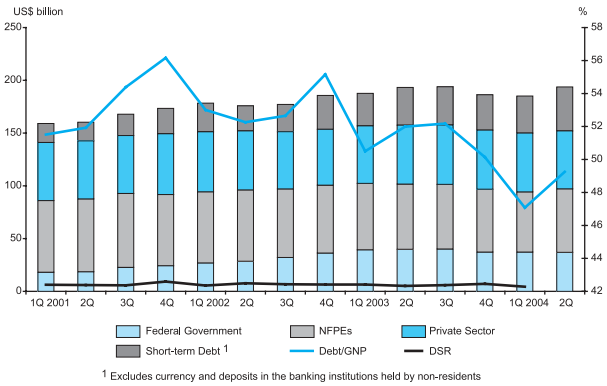
transitional and will be reversed upon maturity. Nonetheless, short-term debt are at low levels, accounting for 21.5% of total external debt, and is about 20.3% of the net international reserves (as at end-June).

External Debt Outstanding

	2003	2004	
	End-June	End-March	End-June [p]
	RM billion		
Medium & Long-term debt	157.4	150.0	152.1
Public sector	101.7	94.3	97.2
Private sector	55.7	55.7	54.9
Short-term debt[1]	35.8	35.2	41.7
Total external debt	193.2	185.2	193.7
- US$ billion equivalent	50.9	48.7	51.0

[1] Excludes currency and deposits held by non-residents with banking institutions.
[p] Preliminary
Source: Ministry of Finance, Malaysia and Bank Negara Malaysia

External Debt Outstanding

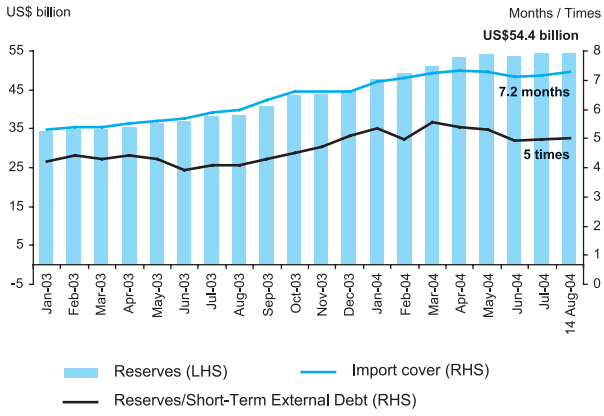


International reserves strengthened further

The **international reserves** of Bank Negara Malaysia strengthened further in the second quarter of 2004, increasing by RM9.7 billion (US$2.5 billion) to stand at RM204.8 billion (US$53.9 billion) as at 30 June 2004. The increase in reserves during the quarter arose mainly from the continued high repatriation of export earnings, inflows of FDI and portfolio funds and drawdown of external loans. The reserves level has also taken into account the quarterly foreign exchange revaluation adjustment amounting to a loss of US$506 million.

The reserves increased further to RM206.9 billion (US$54.4 billion) as at 14 August 2004, reflecting the sustained repatriation of export earnings and inflows of portfolio investment. The reserves level is sufficient to finance 7.2 months of retained imports and is 5 times the short-term external debt.

Net International Reserves (as at end period)

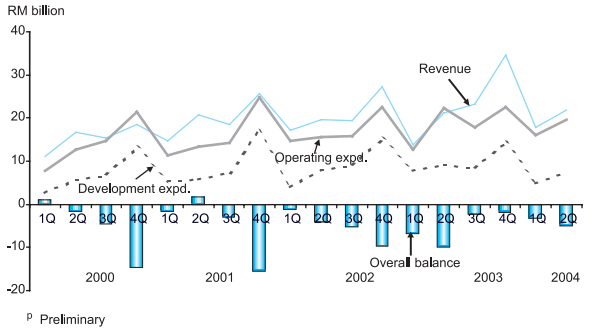


Lower fiscal deficit

Stronger revenue collection and lower expenditure resulted in a lower fiscal deficit for the Federal Government of RM4.9 billion or 4.5% of GDP in the second quarter (2Q 2003: -10.5% of GDP). For the first half of the year, the fiscal deficit amounted to 3.8% of GDP.

Revenue collection during the quarter was higher from both petroleum income tax and most major categories of indirect taxes. In line with its fiscal consolidation stance, total expenditure of the Federal Government

Federal Government Finance [p]



[p] Preliminary

declined at an annual rate of 13.8%. The bulk of the development expenditure was channelled to transport, education, health as well as agriculture and rural development. Given the ample liquidity in the domestic market, funds were raised entirely from domestic sources to finance the deficit. As at end-June 2004, total outstanding debt of the Federal Government amounted to RM197.8

Federal Government Finance [p]

	2003		2004		
	2Q	1H	1Q	2Q	1H
	RM billion				
Revenue	21.2	34.9	17.7	21.8	39.6
% growth	*8.1*	*-5.0*	*29.3*	*2.9*	*13.3*
Operating expenditure	22.2	35.0	16.2	19.7	35.9
% growth	*42.2*	*15.3*	*26.7*	*-11.4*	*2.5*
Current account	**-1.0**	**...**	**1.6**	**2.1**	**3.7**
% of GDP	***-1.1***	***...***	***1.5***	***1.9***	***1.8***
Gross development expenditure	9.1	16.9	4.9	7.3	12.1
% growth	*12.7*	*41.6*	*-38.0*	*-19.9*	*-28.3*
Loan recoveries	0.1	0.2	0.1	0.2	0.3
Overall balance	**-10.0**	**-16.8**	**-3.2**	**-4.9**	**-8.1**
% of GDP	***-10.5***	***-8.9***	***-3.1***	***-4.5***	***-3.8***
Memo item:					
Total gross expenditure	**31.3**	**51.9**	**21.0**	**27.0**	**48.0**
% growth	*32.2*	*22.7*	*2.1*	*-13.8*	*-7.5*
Total Federal Government debt (as at end period)	182.1	182.1	194.3	197.8	197.8
% of GDP	*46.2*	*46.2*	*46.5*	*47.3*	*47.3*
Domestic debt	142.3	142.3	157.0	160.8	160.8
% of GDP	*36.1*	*36.1*	*37.6*	*38.5*	*38.5*
External debt	39.9	39.9	37.3	37.0	37.0
% of GDP	*10.1*	*10.1*	*8.9*	*8.9*	*8.9*

p Preliminary

billion or 47.3% of GDP. The external debt of the Federal Government continue to remain low, accounting for 19.1% of the nation's outstanding external debt.

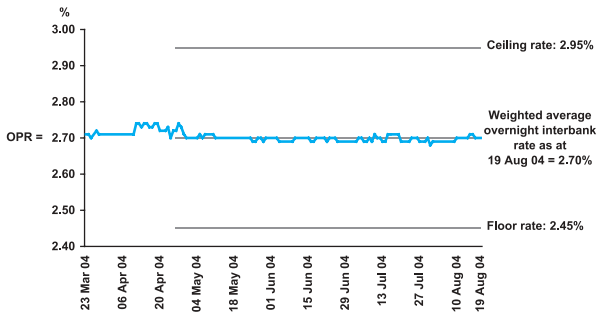
MONETARY AND FINANCIAL DEVELOPMENTS

Monetary policy continued to support growth

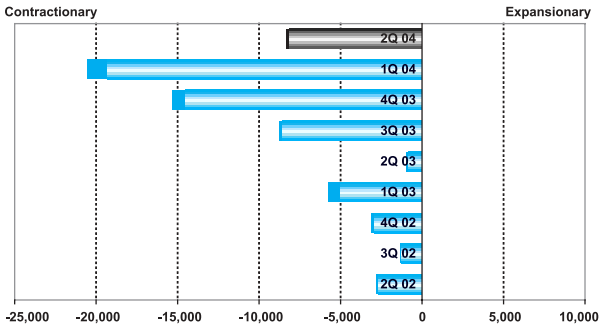
Monetary policy remained supportive of growth. While inflation has remained benign, the ample liquidity together with prevailing low interest rates effectively supported the financing needs of the private sector.

A major change in the system of implementing monetary policy occurred during the quarter following the introduction of the new interest rate framework on 26 April 2004. The Overnight Policy Rate (OPR) replaced the 3-month Intervention Rate as the indicator of monetary policy stance. The new interest framework did not represent a change in monetary policy stance. To reflect this, the OPR was set at the prevailing overnight interbank rate of 2.70%. Transition to the new framework was smooth as market participants responded within expectations. The daily weighted average of the overnight interbank rate moved within a narrow range of 2.68% - 2.74%, averaging 2.70%, in the period 26 April - 19 August. Interbank rates at other tenures continued to remain low. The spread between the KLIBOR rates and interbank rates narrowed during the period. Bank Negara Malaysia absorbed additional liquidity from external operations to maintain stable monetary conditions.

Daily Weighted Average Overnight Interbank Rate



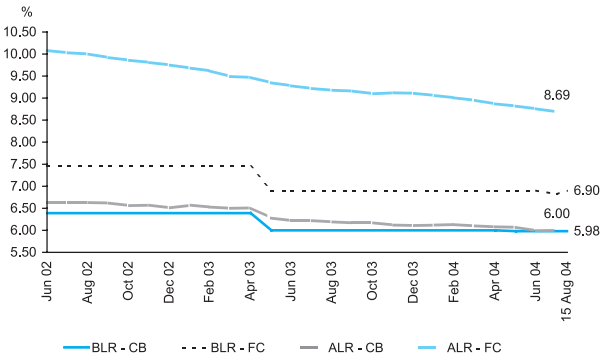
BNM Liquidity Operations
(During the quarter, RM m)



Under the new interest rate framework, each banking institution announces their own base lending rates (BLR) based on their cost structure and business strategies. Following this liberalisation of the BLR formula, one bank quoted lower BLR. As a result, the average BLR of commercial banks (CBs) was only slightly lower at 5.98% as at 15 August 2004 (6.00% at end-March) while the average BLR of finance companies (FCs) remained unchanged at 6.90%. The average lending rates (ALRs) of the CBs and FCs continued to decline during the quarter, to 6.00% and 8.69% respectively at end-July (6.10% and 8.95% respectively as at end-

March). This reflected the larger proportion of new loans priced at lower rates.

Lending Rates: CBs & FCs
(average for the month)



Interest Rates

	2Q 03	1Q 04	2Q 04
	At end-period (%)		
3-month intervention rate *	4.50	4.50	
Overnight Policy Rate (OPR)*			2.70
Interbank rates			
Overnight	2.77	2.71	2.70
1-month	2.99	2.98	2.81
Base lending rates (BLR)			
Commercial banks	6.00	6.00	5.98
Finance companies	6.90	6.90	6.90
Average lending rates			
Commercial banks	6.22	6.10	5.99
Finance companies	9.28	8.95	8.76
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	3.01	3.00	3.00
12-month	3.72	3.70	3.70

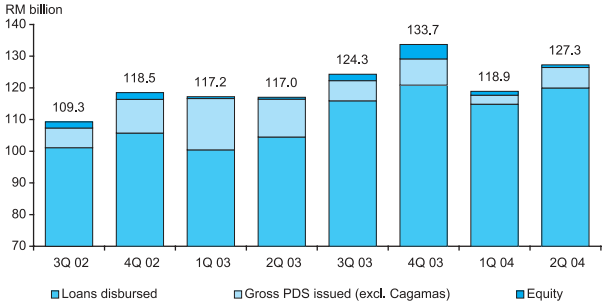
* Effective 26 April 2004, the Overnight Policy Rate (OPR) replaced the 3-month intervention rate as the indicator of the monetary policy stance.

Source: Bank Negara Malaysia

Higher growth in financing to the private sector

Private sector financing remained strong in the second quarter amidst sustained domestic demand and improved external sector performance. Gross private sector financing through the banking system and the capital market was higher at RM127.3 billion during the quarter, increasing at an annual rate of 8.7%. On a net basis, banking system loans and PDS outstanding increased at an annual rate of 8.2% at end-June.

Gross Private Sector Financing through Banking System and Capital Market

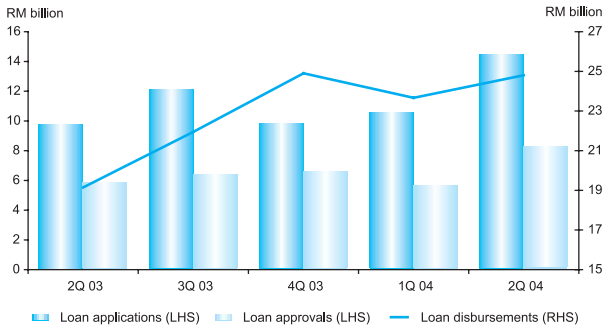


Financing of the Private Sector through Banking System and Capital Market

	During the period (RM billion)				Annual growth (%)		
	2003	2Q 03	1Q 04	2Q 04	2003	1Q 04	2Q 04
Gross total financing	**492.2**	**117.0**	**118.9**	**127.3**	**9.0**	**1.4**	**8.7**
Loans disbursed *	441.7	104.5	114.9	120.0	7.3	14.4	14.8
Gross PDS (excl. Cagamas)	42.8	12.0	2.8	6.5	60.5	-82.5	-46.0
Equity	7.8	0.6	1.2	0.8	-41.5	104.4	42.9
Outstanding total financing (A)+(B)	**57.8**	**14.7**	**6.9**	**16.0**	**10.3**	**8.2**	**8.2**
Banking system	28.1	8.3	3.3	14.2	5.9	5.3	6.4
Loans outstanding (A)	*21.6*	*10.4*	*5.3*	*13.7*	*4.8*	*5.7*	*6.2*
Holding of PDS	*6.6*	*-2.1*	*-2.0*	*0.5*	*23.8*	*0.1*	*8.8*
PDS outstanding (B)	36.2	4.3	1.6	2.3	33.4	17.5	15.4
Memorandum item							
Gross PDS (incl. Cagamas)	51.0	12.9	6.0	7.5	40.8	-65.3	-41.9

* Banking system loans include loans sold to Cagamas.

Bank Lending to SMEs



Loan Indicators

	During the period (RM billion)				Annual Growth (%)			
	2003	2Q 03	1Q 04	2Q 04	2003	2Q 03	1Q 04	2Q 04
Total								
Loan applications	227.6	53.0	58.6	70.6	4.8	-8.2	4.4	33.2
Loan approvals	152.7	38.4	37.2	46.6	11.0	6.8	5.2	21.4
Loan disbursements	441.7	104.5	114.9	120.0	7.3	-0.3	14.4	14.8
Loan repayments	430.5	96.8	112.5	110.3	6.9	-3.3	11.5	14.0
Change in loan outstanding *	21.6	10.4	5.3	13.7	4.8	4.2	5.7	6.2
Of which:								
Business enterprises								
Loan applications	124.9	28.4	30.5	38.2	-7.7	-16.1	-9.9	34.2
Loan approvals	77.2	19.9	17.2	23.6	12.7	11.5	-5.1	18.3
Loan disbursements	303.4	71.5	78.2	82.8	7.6	-2.8	14.9	15.8
Loan repayments	299.6	66.3	75.6	76.0	8.6	-4.0	8.9	14.6
Change in loan outstanding *	-5.2	3.8	-0.4	5.4	-2.4	-1.9	-0.6	0.2
SMEs								
Loan applications	44.5	9.7	10.5	14.5	n.a.	n.a.	-17.8	49.0
Loan approvals	25.7	5.9	5.7	8.3	n.a.	n.a.	-16.1	41.4
Loan disbursements	87.1	19.1	23.7	24.8	-6.9	n.a.	12.3	29.5
Change in loan outstanding *	7.4	1.3	-1.1	2.9	10.0	5.1	5.3	7.4
Large corporations								
Loan applications	80.4	18.7	20.0	23.7	n.a.	n.a.	-5.0	26.6
Loan approvals	51.5	14.0	11.5	15.2	n.a.	n.a.	1.5	8.6
Loan disbursements	216.4	52.3	54.6	58.0	-6.9	n.a.	16.0	10.7
Change in loan outstanding *	-12.7	2.5	0.6	2.5	-8.8	-5.5	-3.9	-3.8
Households								
Loan applications	98.5	24.0	27.2	32.2	20.2	9.5	29.9	34.3
Loan approvals	72.0	18.2	19.3	22.8	7.6	1.7	20.8	25.5
Loan disbursements	114.5	27.3	30.8	31.5	8.9	6.2	17.5	15.4
Loan repayments	94.1	21.6	26.8	25.6	12.4	6.5	19.2	18.4
Change in loan outstanding *	26.2	5.9	6.0	8.1	12.8	12.8	12.9	13.6

* The annual growth is for end-period.

Source: Bank Negara Malaysia

Loans by Sector

	Loans disbursed					Loans out-standing
	During the period				Share of total	Share of total
	2003	2Q 03	1Q 04	2Q 04		
	RM billion				%	
Business enterprises	303.4	71.5	78.2	82.8	69.0	44.3
Large corporations	*216.4*	*52.3*	*54.6*	*58.0*	*48.3*	*27.3*
SMEs	*87.1*	*19.1*	*23.7*	*24.8*	*20.7*	*17.0*
Households	114.5	27.3	30.8	31.5	26.2	49.7
By sector						
Agriculture, hunting, forestry and fishing	11.1	2.5	3.1	3.7	3.1	2.3
Mining and quarrying	1.7	0.3	0.5	0.4	0.3	0.2
Manufacturing	110.4	26.7	27.2	30.7	25.6	12.9
Broad property sector	78.9	19.0	21.0	21.7	18.1	40.1
Construction	*27.5*	*6.6*	*7.0*	*7.3*	*6.1*	*6.0*
Purchase of residential property	*35.6*	*8.6*	*9.5*	*9.7*	*8.1*	*25.3*
Purchase of non-residential property	*9.7*	*2.3*	*2.7*	*2.9*	*2.4*	*6.0*
Real estates	*6.1*	*1.5*	*1.8*	*1.9*	*1.5*	*2.8*
Electricity, gas and water supply	6.0	1.6	1.5	1.5	1.2	1.1
Wholesale, retail, restaurants and hotels	70.1	17.5	18.3	20.0	16.6	8.2
Transport, storage and communication	12.0	3.5	2.5	2.8	2.3	2.4
Finance, insurance and business services	36.7	6.2	10.6	8.8	7.3	6.0
Consumption credit	72.4	17.3	19.5	20.4	17.0	19.3
Of which:						
Credit cards	*30.5*	*7.1*	*8.4*	*8.6*	*7.2*	*2.6*
Purchase of passenger cars	*24.5*	*6.0*	*6.0*	*7.1*	*5.9*	*13.4*
Purchase of securities	12.9	2.7	3.7	2.8	2.4	4.0
Purchase of transport vehicles excluding passenger cars	1.2	0.2	0.3	0.2	0.1	0.5
Others	28.3	6.9	6.8	7.1	5.9	3.1
Total	**441.7**	**104.5**	**114.9**	**120.0**	**100.0**	**100.0**

Source: Bank Negara Malaysia

Continued expansion in both private consumption and investment activities was reflected in strong growth in the major bank loan indicators. Higher bank lending activity was registered across the three main groups of borrowers, namely SMEs, large businesses and households.

Total loan disbursements was higher amounting to RM120 billion or at an annual growth rate of 14.8% in the second quarter. Disbursements to businesses were higher by 15.8% on an annual basis to RM82.8 billion, continuing to account for close to 70% of total disbursements during the quarter. The bulk of disbursements to businesses were channelled to the manufacturing sector (37.1% of total disbursements to businesses); the wholesale

and retail trade, restaurants and hotels sector (24.1%); and the finance, insurance and business services sector (10.6%). The strong disbursements contributed to higher business loans outstanding in the second quarter. The higher business loans outstanding, particularly of large corporations, partly reflected several new, large long-term loans during the quarter. The forward-looking indicators, applications and approvals of business loans, were notably higher in the second quarter, increasing by 33.4% and 18.3% respectively.

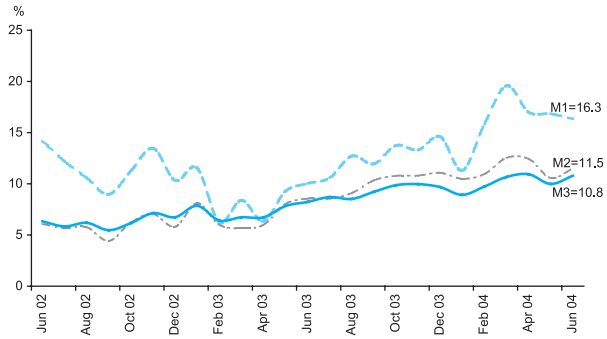
Bank lending to small and medium enterprises (SMEs) continued to increase in the second quarter. Loan disbursements to the sector, which increased at an annual rate of 29.5%, contributed to the growth in loans outstanding to 7.4% at end-June. A total of RM8.3 billion was approved to 22,161 SME accounts during the quarter (1Q: RM5.7 billion approved to 18,703 SME accounts).

Total loan disbursements to households remained strong, amounting to RM31.5 billion. As in the previous quarter, disbursements to households continued to be supported by the robust growth in loans for the purchase of residential property (30.8% of total disbursements to households), credit cards (27.4%) and the purchase of passenger cars (22.4%). Both forward-looking loan indicators showed a sustained trend in the demand for bank financing by households. Loan applications and approvals increased at annual growth rates of 34.5% and 25.5% respectively at end-June. While lending to households was sustained during the quarter, the non-performing loans (NPLs) of the sector remained manageable. As a proportion of total household loans, the gross NPL ratio of the sector was slightly lower at 7.6% at end-June (7.9% at end-March). In particular, the NPL ratios for residential property loans and credit card loans were contained at 8.6% and 4.2% respectively at end-June (8.8% and 4.3% respectively at end-March).

Sustained expansion in broad money

Reflecting the robust economic activity in the second quarter, the annual growth rates of all the monetary aggregates remained high. M3 increased by 10.8% at end-June (10.7% at end-March). The expansion in M3 of RM10.3 billion during the quarter was driven mainly by higher claims on the private sector (2Q: +RM12.4 billion; 1Q: +RM3.8 billion). This was

Monetary Aggregates: Annual Growth



M3 Determinants

	Change during the period				
	Yearly		Quarterly		
	2002	2003	2Q 03	1Q 04	2Q 04
	RM billion				
M3	31.6	48.5	8.7	18.9	10.3
Net claims on Government	11.5	12.9	5.3	-6.0	-2.0
Claims on private sector	27.7	31.3	8.6	3.8	12.4
Net external operations *	1.2	20.8	0.3	33.3	6.0
Other influences	-8.9	-16.5	-5.5	-12.2	-6.2

*Pre-revaluation
Source: Bank Negara Malaysia

mainly due to higher bank lending as holdings of securities by the banking institutions declined during the quarter. The external sector also exerted a positive impact on money supply. Sustained repatriation of export proceeds and some portfolio and FDI inflows contributed to the increase in reserves.

Higher new funds raised in the capital market

The capital market remained an important source of financing for the private sector in the second quarter, as corporations continued to take advantage of the low interest rate environment. New issuances of private debt securities (PDS) were higher, amounting to RM7.5 billion (1Q 2004: RM6 billion). In terms of non-Cagamas PDS issuances, funds were raised by 22 companies, of which about half were from the manufacturing and property sectors. More than half of the total funds raised were channelled towards new activities (55.2%). The new issues were mainly in the form of MTNs, convertible bonds and asset-backed securities. On a net basis, the gross issues were offset by large redemptions amounting to RM8.6 billion. In the equity market, RM800 million was raised, of which RM353 million was from 14 initial public offerings. There were 13 new listings on the KLSE during the period, with five listings on the Main Board, three on the Second Board and five on MESDAQ.

The Government raised funds amounting to RM16.7 billion. Of this, RM14.8 billion was through one new issue and three reopenings of MGS, while RM1.4 billion was from a new issue of GII. The public sector also redeemed MGS, GII and Khazanah bonds amounting to RM12.7 billion, resulting in net financing of RM4 billion.

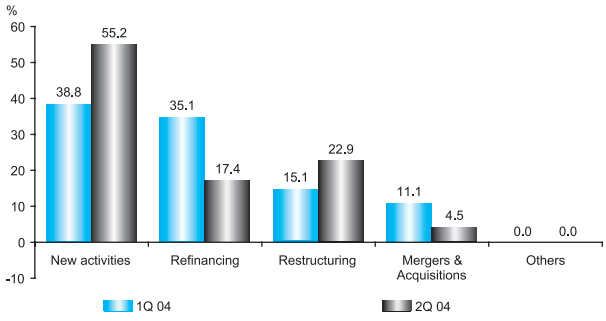
Total net funds raised in the capital market amounted to RM3.8 billion, despite higher redemptions by both the private and public sectors.

Funds Raised in the Capital Market

	1Q 03	2Q 03	1Q 04	2Q 04
	RM million			
By Public Sector				
Malaysian Government Securities (MGS), *gross*	17,730	8,132	11,000	14,763
Less Redemptions	10,300	1,500	5,500	9,700
Less Government holdings	0	0	0	0
Equals Net Federal receipts	7,430	6,632	5,500	5,063
Khazanah Bonds, *net*	878	-138	0	-1,000
Government Investment Issues (GII), *net*	1,729	0	0	-560
Malaysia Savings Bond, *net*	-2	-2	-455	0
Merdeka Savings Bond, *net*	0	0	500	497
Net Funds Raised	10,035	6,491	5,545	4,001
By Private Sector				
Shares	587	584	1,200	834
Debt securities	17,405	12,911	6,041	7,498
Private Debt Securities excluding Cagamas)	*16,185*	*11,966*	*2,836*	*6,463*
Cagamas	*1,220*	*945*	*3,205*	*1,035*
Less *Redemptions*	*2,176*	*9,602*	*6,928*	*8,558*
Net Issues	15,229	3,310	-887	-1,060
Net issues (excluding Cagamas)	*15,536*	*4,135*	*-2,092*	*75*
Net Funds Raised	15,816	3,894	314	-226
Total Net Funds Raised	25,851	10,385	5,858	3,775
Short-term papers and notes, *net*	1,620	-1,437	-269	-1,213
TOTAL	27,471	8,949	5,589	2,563

* Refers to Commercial Papers and Cagamas Notes only.

Private Debt Securities Issued by Purpose
(% of total)



KLSE CI weakened on adverse external developments

The KLSE CI declined in the second quarter of 2004 as global and regional developments affected the performance of several regional bourses, particularly in April and May. Sentiment was adversely affected primarily by concerns over the impact of potentially slower growth in P.R. China, the prospect of increases in US interest rates and the consequences of higher oil prices on the global economy. The KLSE CI improved marginally at the end of May following the announcement of strong first quarter economic growth and better-than-expected quarterly earnings announced by several listed companies.

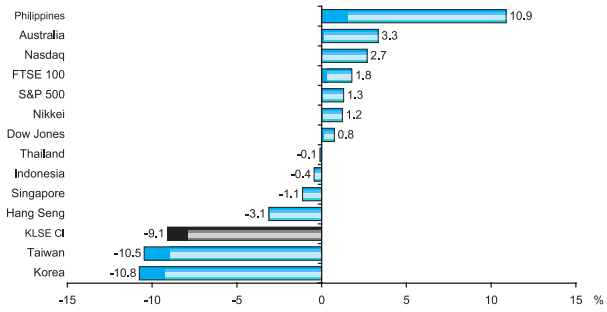
In the second quarter, the KLSE CI declined by 9.1% to 819.9 at end-June (end-March 2004: 901.9). Market capitalisation at the end of the quarter was lower by 9.7% at RM653.9 billion (end 1Q 2004: RM724.2 billion) while the average daily turnover for the quarter was lower at 331.5 million units.

Bursa Malaysia: Selected Market Indicators

	As at end				
	1Q 03	2Q 03	4Q 03	1Q 04	2Q 04
Price Indices					
Composite	635.7	692.0	793.9	901.9	819.9
EMAS	154.0	170.2	195.6	219.8	197.3
Second Board	93.0	109.0	140.6	135.3	117.2
Average daily turnover					
Volume (million units)	213.6	286.7	658.1	650.6	331.5
Value (RM million)	367.1	457.2	1,179.8	1,325.7	714.6
Market Capitalisation (RM b)	478.3	532.5	640.3	724.2	653.9
No. of companies Listed	874	877	906	923	934

Source: Bursa Malaysia

Performance of Selected Global and Regional Markets in the Second Quarter of 2004



Bursa Malaysia: Turnover of Corporate Securities

	During the period									
	1Q 03		2Q 03		4Q 03		1Q 04		2Q 04	
	million units	RM million	million units	RM million	million units	RM million	million units	RM million	million units	RM million
Turnover	12,387	21,294	17,776	28,349	40,144	71,970	37,737	77,036	15,192	32,857
of which:										
Main Board	10,609	19,397	14,421	24,648	27,495	51,391	27,626	61,454	11,230	27,790
of which:										
Consumer Products	310	1,481	509	1,959	944	3,086	1,173	3,905	514	1,895
Industrial Products	711	1,535	1,429	2,105	3,735	5,369	4,087	6,067	1,660	2,841
Construction	1,482	1,687	1,181	1,796	2,177	5,415	1,693	4,044	654	1,449
Trading / Services	2,791	7,165	3,329	9,009	6,118	16,632	5,632	19,975	2,588	9,206
Finance	1,532	3,784	1,908	4,422	3,468	9,065	4,536	14,521	1,899	6,061
Properties	1,370	966	2,942	2,210	5,138	5,446	4,159	5,145	1,580	2,185
Plantations	296	1,283	307	1,129	638	1,981	762	3,106	424	2,112
Mining	48	91	53	92	36	102	43	140	5	30
Second Board	1,591	1,807	2,685	3,377	10,100	18,229	6,258	11,249	2,787	3,995

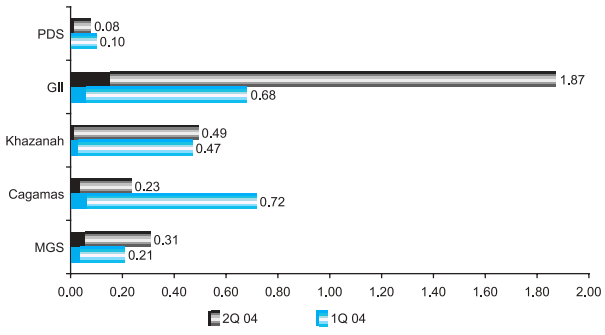
Source: Bursa Malaysia

Higher secondary trading in the bond market following issuances of Government securities

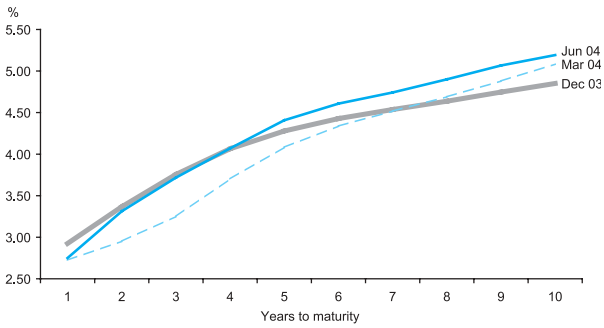
Trading in the secondary market was higher in the second quarter compared with the first quarter, following several issuances of Government securities. For the quarter as a whole, trading activities were concentrated in the 3-5 year Government and quasi-Government securities, which accounted for 85% of total trade. In terms of liquidity, the GII and Khazanah bonds were the most liquid papers, with liquidity ratios of 1.87 and 0.49 respectively.

The medium to long end of the MGS benchmark yield curve shifted upwards in the second quarter. Market sentiment was weak, influenced primarily by concerns over the sooner than expected interest rate increases in the US, coupled with the improvement in the domestic economy. However, the MGS supply in June met market's expectations and lifted market sentiment towards the end of June. In addition, the official announcements that there would be no change to domestic interest rate policy removed market uncertainties. As a result, the MGS benchmark yield curve was only marginally higher in June compared to May.

Liquidity Ratio: Turnover/Outstanding



Trend in MGS Yield

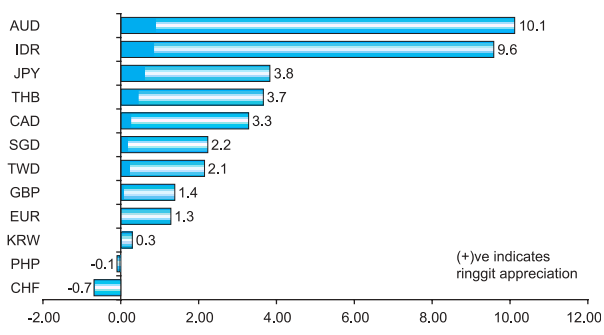


Performance of the ringgit

In the second quarter of 2004, the ringgit appreciated against the yen, pound sterling and euro. The US dollar strengthened against these currencies largely on account of the expected increase in US interest rates.

With the appreciation of the US dollar, the ringgit also strengthened against most of

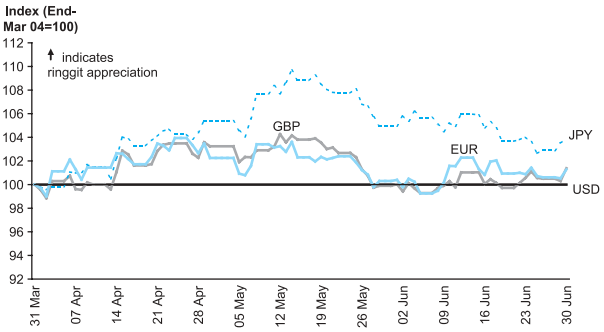
Summary of Ringgit Performance Against Selected Currencies
Percent Change (1 April- 30 June 2004)



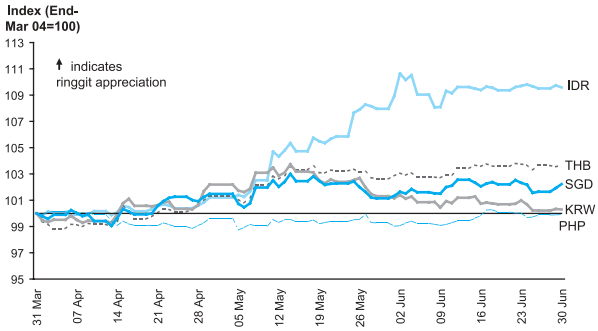
the regional currencies. In the second quarter, most of the regional currencies generally weakened on account of concerns over the impact of potentially slower growth in P.R. China, higher oil prices and the implications of the expected rise in interest rates in the US. Uncertainty over the political atmosphere in several countries, particularly in the lead up to elections also influenced the performance of their currencies.

Notwithstanding the volatility of the exchange rates of major and regional currencies, the ringgit's trade-weighted value continued to remain consistent with the underlying fundamentals of the economy.

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	1Q 04	2Q 04	30 Jun 97	02 Sep 98	1Q 04
US dollar	2.5235	3.8000	3.8000	3.8000	-33.6	0.0	0.0
Euro	-	-	4.6522	4.5933	-	-	1.3
Pound sterling	4.1989	6.3708	6.9667	6.8719	-38.9	-7.3	1.4
100 Japanese yen	2.2088	2.7742	3.6334	3.4991	-36.9	-20.7	3.8
Singapore dollar	1.7647	2.1998	2.2633	2.2139	-20.3	-0.6	2.2
100 Thai baht	9.7470	9.3713	9.6239	9.2841	5.0	0.9	3.7
100 Philippine peso	9.5878	8.8302	6.7580	6.7640	41.7	30.5	-0.1
100 Indonesian rupiah	0.1038	0.0354	0.0442	0.0404	157.1	-12.3	9.6
100 Korean won	0.2842	0.2827	0.3308	0.3298	-13.8	-14.3	0.3

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

DEVELOPMENTS IN THE BANKING SYSTEM

The financial position of the banking system remained sound in the second quarter of 2004 with a high level of capitalisation, enhanced profitability and improved asset quality. The strengthened financial position enabled the banking system to continue to support economic growth through expanded lending activities.

The high level of capitalisation sustained

The risk-weighted capital ratio (RWCR) and core capital ratio (CCR) of the banking system improved to 13.8% and 11.3% respectively. The stronger capital position was attributed to the higher growth of RM3.1 billion (+4.3%) in the capital base, mainly due to capital raising exercises through issuance of subordinated debt papers as well as inclusion of audited profits by a number of banking institutions. Meanwhile, increase in lending activities has led to higher risk-weighted assets by RM17.1 billion (+3.2%).

Capital Position Remained Strong

	2003				2004	
	1Q	2Q	3Q	4Q	1Q	2Q
Capital						
CCR (%)	11.0	11.1	10.9	11.1	11.1	11.3
RWCR (%)	13.2	13.7	13.4	13.7	13.7	13.8

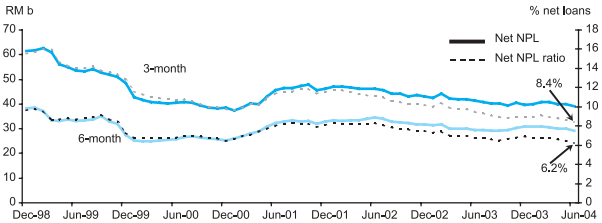
Enhanced profitability on account of stronger income

Pre-tax profit of the banking system increased further by RM0.2 billion (+6.7%) to RM3.3 billion during the second quarter. The increase in pre-tax profit was driven by higher net interest income (+RM141.8 million), fee-based income (+RM55 million) and net investment gains (+RM274.9 million). The increase in revenue was, however, partially moderated by higher operating costs (+RM134.9 million or +4.7%). The annualised return on average assets and equity of the banking system stood at 1.6% and 18.7% respectively (1Q 2004: 1.5% and 17.9%).

Further improvement in asset quality

Net non-performing loans (NPLs) based on the 6-month classification improved by 3.7% to RM29.3 billion at end-June 2004. The improvement was due mainly to higher recoveries and reclassifications and lower incidences of new NPLs. As a result of lower NPLs and higher loan growth, the net NPL ratio declined by 0.5 percentage point to 6.2% at end-June 2004, the lowest level since 1998. Similarly, the net NPL ratio based on the 3-month classification declined to 8.4% (Mar 2004: 9%).

Banking system: Non-performing loans



Malaysian Banking Summit 2004
15 April 2004, Kuala Lumpur

"Towards World-Class Banking - Efficient, Effective and Resilient Banking System"

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

I. Introduction

The turn of the century has seen a significant transformation of our banking sector. The changes have been driven by the new emerging economic opportunities, changing customer requirements, new technology, the more competitive environment and changes in the regulatory and supervisory framework. This period has also seen significant progress achieved in the strengthening of the domestic banking system. The strengthening of the banking sector has been driven by the restructuring, re-engineering, rationalisation and consolidation that has been undertaken during this period. Indeed, this progress has been achieved against a background of a challenging global financial and economic environment. As we strive for high performance benchmarked against international standards, we must not lose sight of the context of the financial and economic environment in which we operate. Central to this is a common vision of developing a world class banking system that is best able to serve the nation and thus contribute to economic growth in an environment of financial stability. The expectations are thus for the banking system to be able to provide the intermediation function that is effective, efficient, resilient, and that supports sustainable economic growth.

To ensure that the financial system is best placed to serve the economy, important attention has been directed to enhance the financial infrastructure to increase access to financing to meet the new, more complex and differentiated demands of the various sectors of the economy, to enhance efficiency in the banking institutions and the functioning of the financial markets, and to put in place other supporting infrastructure that reinforce the achievement of these objectives. These efforts have been complemented by measures to ensure the soundness and stability of the system.

High performance of the industry would require the banking institutions to increasingly offer greater product differentiation and value added services. This requires resources to be directed to research and development to introduce a wider range of structured and customised products and to become a one-stop financial services solution provider. The

ability of the banking institutions to address the needs and preferences of specific segments and focus on customer relationships in a timely and cost effective manner is key to achieving competitive advantage and long-term sustainability.

II. The Journey towards Realising the Vision

The banking system policy has evolved from financial sector restructuring during the late 1990s to institutional development and capacity building, and the development of supporting infrastructure to enhance efficiency and the strengthening of prudential regulation to enhance resilience and preserve stability. In terms of the development of the financial infrastructure, efforts were intensified towards evolving a more diversified financial infrastructure to facilitate the economic transformation into a more diversified economic structure. This has involved the development of a more diversified financial structure anchored by a more efficient and resilient banking system, to support economic transformation and growth. The strategies to achieve this vision are outlined in the Financial Sector Masterplan launched in March 2001.

Three years into the Financial Sector Masterplan, positive results have been achieved on several fronts.

- The capacity of the banking sector now has strengthened with the level of capitalisation at its strongest, reflected by the risk-weighted capital ratio of the banking system that has been consistently maintained at above 13%. This has enhanced the resilience of the banking sector and is reflected in the ability of the banking system to weather a number of adverse external developments in the recent period, without any destabilising and disruptive consequences.

- Following the consolidation exercise in 2002, the banking system today is characterised by larger and better-capitalised domestic banking institutions operating within larger banking groups, benefiting from economies of scale to provide a wider range of products and services to cross sell, and therefore widen the reach nationwide.

- Domestic banking institutions have also embraced a higher level of technology and improved business processes.

- There have been marked improvements in the level of efficiency. Operating cost of domestic banking institutions has declined from 41.2% in 2001 to 40.3% of total income in 2003. There have also been improvements in turnaround time in processing loans and in response time in resolving customer problems.

- There has also been a higher level of innovation and introduction of new products and services to meet the customer needs that are becoming increasingly complex and sophisticated. These services include wealth management, structured investment products, bancassurance and Islamic financial products.

- New delivery channels through innovative technology-based mechanisms such as internet and mobile banking have enhanced the delivery of products and services as well as widened access to banking services.

- Despite a more competitive environment, domestic banking institutions have been able to sustain their market share at 80%. The domestic banks commanded a 83% share of the outstanding loans to the small and medium enterprises, while their market share in the credit card business has increased from 46% in 2000 to 54% of total credit cards issued in 2003.

- With the increased investment in risk management systems, the risk management capability in the banking sector has been further strengthened on all fronts through increased availability of risk management tools. This has been reinforced by enhanced prudential policies. Banking institutions are now better positioned to withstand challenges arising from unfavourable developments.

- The resumption of credit growth has now gathered momentum to meet the growing financial demands of the economy, while keeping risks at acceptable levels. There has also been significant shifts in the asset portfolio composition. Following the initiatives to promote SME access to financing, banking sector loans to this sector have increased significantly to account for 38% of total business loans. Retail lending for consumption has also increased. The strong banking system has been well positioned to meet customer demand for financial services. Indeed, the banking industry has continued to benefit from strong demand for household credit.

- The enhancement to the legal infrastructure including enactment of the Payment Systems Act 2003 will serve to strengthen Bank Negara Malaysia's payment system oversight, and to provide the legal framework to ensure that payment systems are protected from disruptions and its consequent effects on financial stability.

- The Islamic financial system has evolved to form a vital component of the Malaysian financial system. The Islamic banking system now accounts for almost 10% of the total assets of the banking system, from 6.9% in 2000. Significant milestones have been achieved in developing the Islamic financial infrastructure as well as in the development of the prudential regulatory and supervisory framework in meeting the changing requirements of the new economy.

- Following the intensified consumer awareness and literacy programme that has been implemented, there is evidence of growing consumer involvement in product development and delivery. Customers are demanding greater service quality and product offerings to fulfil their preferences and requirements.

III. Philosophy of Financial Regulation

The ability of regulators, banking institutions and market participants to respond to the changing financial landscape is key to the development of an efficient, effective and resilient banking system. Given the unique role of the banking system in the economy, and the importance of maintaining public confidence and trust in the banking system, regulation and supervision is a vital component of a well-developed financial system.

In designing and implementing financial regulation, a careful balance is made between achieving the objective of promoting efficiency in the banking system and the objective of maintaining financial stability. Consideration also needs to be given to the socio-economic agenda. In addition, a fine balance needs also to be made between the objective of promoting competition and innovation and that of maintaining prudence and stability in the financial system.

In line with this, the regulatory approach has become increasingly more "principle-based" rather than "rule-based". To ensure that regulation remains relevant in preserving financial stability, while allowing sufficient flexibility for banking institutions to design their own strategies and market niches, the regulatory approach is increasingly focussed on developing broad prudential guidelines and principles, rather than prescribing common requirements across institutions and activities. The Central Bank is therefore moving away from prescribing detailed rules and regulations to govern the activities of banking institutions. Regulation will instead focus on identifying risks at the system level, and on ensuring that individual banking institutions have the necessary capacity in terms of internal controls and systems to undertake and manage risks. This, therefore, does not mean less regulation.

As the strength of individual institutions is often the first line of defence against any crisis, the responsibility is therefore increasingly on the board and management of individual institutions to strengthen the resilience of the institutions. The Central Bank's focus is increasingly on the need for banking institutions to adopt and promote good governance, integrity, strong internal controls and risk management practices. Greater regulatory scrutiny is undertaken to ensure that the shareholders, board of directors and management of banking institutions are "fit and proper" and have the capacity to discharge their responsibilities and accountabilities. This is reinforced by greater transparency and disclosure requirements. Integrity and transparency is critical for financial institutions to gain public trust and investor confidence.

IV. Strategic ICT Investment as Driver for Performance

In an era where advancements in technology have significant impact on our daily activities, we are constantly presented with the challenge to make decisions on the best ICT products that will meet our preferences and requirements. Similarly, in the financial industry, advancements in ICT have certainly had a significant impact on how businesses operate and on the landscape that they operate in. The financial services industry is

one of the single largest users of technology. The rapid advancement of technology will indeed continue to drive improvements in the banking system, particularly new technology with respect to information management systems, product development, risk management and delivery of products and services. A recent industry survey has estimated that the global ICT spending on enhancement of branch network alone was more than USD15 billion in 2001 and expected to increase to USD20 billion by 2005.

Not all of such investments however, will produce the desired improvements. IT investments need to be backed by strong business justification and implementation consideration. New technologies need to be adopted with adequate review as to how it will operate within the broader organisational context. This also applies to initiatives to implement organisation-wide IT enhancements, so that it will bring about the intended results. Indeed such investments as in the CRM application need to be well tailored to individual business models.

Wasteful investment needs to be avoided. The key is to align and integrate ICT into the business models. As technology end-users, the industry is faced with a multitude of product offerings with solutions to improve processes and business activities. This has required sound decision-making. The assessment on the return on IT investment needs to be based on a longer time horizon, incorporating both qualitative and quantitative benchmarks to ensure that it will translate into improved performance. A key part towards achieving such return targets would be to ensure smart deployment of IT applications within the organisation. Underlying this process is the need for close interaction between technology and business operators in the customisation stage. Such new applications need to be reviewed as to how they will contribute towards improving product and services delivery, aid in risk management activities, and enhance management capability.

V. Opportunities from Regional Integration

Another important development that is taking place is the growing regional integration, driven by increasing intra-regional trade and investment flows. Asia has seen a rising pattern of intra-regional trade and investment where trade between countries in the region now accounts for almost half of Asia's trade from just a fifth over a decade ago. Malaysia's share of trade with ASEAN member countries now accounts for 24% of our total trade reflecting higher intra-regional trade (notably, increased imports from lower-cost suppliers such as Thailand, Indonesia and the Philippines) and better economic performance of ASEAN countries. In 2003, Malaysia recorded strong growth in exports of 29.6% to China and 26.7% to Hong Kong. Large businesses and corporations have begun to review their business architecture more aggressively and have moved to relocate their business operations. Such structural shifts driven by new demand patterns and new ways of organising production have led to increased specialisation and complementarity within the region.

ASEAN alone offers a huge growing market of 500 million people. Therein lies the opportunities for the domestic banking institutions, opportunities to support Malaysian businesses and investors who are venturing abroad and opportunities to diversify across geographical sectors and across product range. The role of banking institutions needs to extend beyond the traditional role of being a financier, to manager of financial relationships. Each time a borrower ventures abroad, new opportunities are created. As managers of such financial relationships, banking institutions can be part of this process by fostering the banking relationship into a long-term strategic partnership, and by providing the right range of financial products.

These opportunities may also be realised by setting up presence in new markets. It can also be in the form of partnerships or strategic acquisition of an existing banking institution in a foreign market. Mergers or alliances in services and products can be pursued through co-branding or complementary products, delivery channels and marketing or product development. Alliances can also be formed to capitalise on intangible assets such as human capital. Such alliances can also translate into increased innovation in processes, structures, business models and ultimately innovation in products and services. Indeed, strategic alliances have been growing, cutting across many industries and business segments. As banking institutions are able to fulfil the differentiated demands and expectations, this would enhance their capacity to compete in both the domestic and external markets and thus be able to capture the opportunities accorded from liberalisation and globalisation.

VI. Customer-centric Banking System

As the financial landscape evolves and competition intensifies, banking institutions need to respond to the changing market needs, and continually reassess strategies and alternatives in this rapidly changing and dynamic market and shift from just the traditional offerings. Consumers are becoming increasingly discerning and demanding. Strategic decisions about the future needs to be made to sustain the ability to offer and deliver unique value propositions to customers whilst at the same time effectively managing customers' expectations.

An area that banking institutions may venture into is micro-financing. Micro-enterprises perform an important economic activity for a large segment of the country's population. While institutional arrangements are being put in place to increase access to financing for such micro-enterprises, the banking sector with its large network of branches can become an important channel for such financing. These could be provided via a micro-financing window. Global experience has shown that such micro-financing operations can be successful and profitable with good loan portfolio quality.

As part of the efforts to raise the quality performance in the financial services sector, Bank Negara Malaysia initiated a nation-wide survey in 2003 to assess the requirements, expectations and the satisfaction level of consumers on the quality of products and

services offered by banking institutions. While the primary objective of the study is to develop an index on the levels of quality of customer service, the findings indicate that the real issues in enhancing the industry's level of performance goes beyond this, towards developing a stronger customer-centric orientation. The findings provide a discernable indication of the differences in customer needs and requirements, and identify specific areas where customer-orientation issues tend to arise.

Let me briefly share some of the key findings of the survey. The findings reveal that while the general level of customers' satisfaction is favourable, the relationship between customers and the banking institutions needs to be improved. While one in three customers is satisfied with the banking relationship, it did not imply loyalty.

The survey also identified factors that customers are looking for in their banking relationship. Among the primary needs are the quality of interface with bank staff; and the effectiveness and efficiency of delivery channels, in particular branch banking and ability to deliver effective service in transacting and the efficiency in application processing.

Secondary requirements represent potential leverage factors which can be used to substantially improve overall customer relationship. These include product innovativeness with value-added features and electronic banking including internet banking. These secondary core needs would become primary drivers and important elements in banking relationship.

Additionally, the survey indicated that younger and middle-income individuals, a growing customer segment, prefer to use ATMs and electronic channels. Another growing segment is the "Older Affluent", in the middle and higher income levels. Given the growing size of this customer segment and their higher income level, they require a wider range of innovative investment products that offer safe and steady returns as well as personalised financial advisory services.

The challenge therefore is for the industry to pro-actively respond to these customer priorities now rather than waiting for increased customer churning. Fundamental to achieving greater customer-centricity is to ensure that the staff, processes and orientations are aligned towards fulfilling customers' expectations and delivering superior customer's experience. Of importance is to have clarity of purpose that is communicated, shared and understood by all levels of staff, especially the front-office staff. Having a culture that is built around such commonality of purpose will ensure consistent service performance. Another further aspect is the design of the operational processes with customers' perspective in mind to ensure easy access, speedy and accurate execution of transactions that are responsive to many facets of customers' demands. To facilitate this, it is essential that banking institutions embrace the relevant technology to support business processes, enhance risk management capabilities while at the same time provide seamless access to customers through a wider range of delivery channels. All these need to be supported with an effective human resource management framework that

ensures the availability of best talent and the right skills.

As competition intensifies, banking institutions increasingly must be able to deliver personalised and customised financial solutions. Therefore, it is important for institutions to understand the dynamics of customer segmentation, build customer relationship and address requirements and preferences of specific segments. Understanding specific segments requires banking institutions to understand complex intangibles such as customer behaviour, motivation and life events. Sustainable growth will be very much dependent on the ability to develop lasting and profitable relationships with customers.

Investing in new products in meeting the complex customer needs and demands is important. Equally important is the need to develop an effective communication plan or strategy as a package to product delivery. Even the best of products would not have a good chance of success without a well-conceived communication strategy. This goes beyond marketing and advertisement. It would include educating customers to adapt to the new ways of doing banking transactions or changes being introduced and to use the innovative products being offered. It is also interesting to note that the survey findings clearly indicated the importance of quality interface between customers and banks. As such, numerous interface points need to be reengineered to ensure the right mix of the virtual and physical environment. New branch models have emerged, incorporating features from both virtual and physical environment, to fulfil the varying needs of different localities and market segments.

VII. Conclusion

While the new emerging trends in both the domestic and global economy will have significant implications on the domestic financial landscape, each banking institution will need to be able to formulate differentiated strategies to effectively respond to these forces in a strategic manner. Thus, the ability to precisely assess the institutions individual capabilities and strengths as well as opportunities in this changing environment is key to facilitate effective strategic management at the organisational level. Through this process, I envisage that the domestic financial landscape will evolve into a banking environment characterised by three types of banking institutions that will emerge to meet the future demands of the economy.

a. First, large Malaysian banks with nationwide and regional and international presence that are able to compete with global financial players;

b. Second, banking institutions with nationwide presence that are able to offer a broad range of financial products and services; and

c. Third, specialist niche players delivering specialised value added products and services for specific segments of the market.

The financial services industry has evolved considerably over the recent period.

New emerging trends have provided us with new opportunities in our quest to create a dynamic financial system that will best serve our economy. In striving towards high performance and world-class standards in the industry, we look forward to working with you in this dynamic and challenging environment to achieve this common goal.

Islamic Financial Services Board Summit
Islamic Financial Services Industry and The Global Regulatory Environment
18 May 2004, London

"Approaches to Regulation of Islamic Financial Services Industry"

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

I. Introduction

Preserving financial stability in the Islamic financial system extends beyond the regulatory framework to the building of an intermediation system that is robust and resilient, that is efficient and competitive and that is able to contribute to the growth process. Islamic finance has evolved to become a dynamic industry that has extended beyond domestic borders to become an integral component of the international financial system. Indeed, amidst the changing global financial landscape, the Islamic financial industry has demonstrated its ability to operate in an increasingly more challenging and competitive environment. The challenge before us is to maximise the potential and the seamless opportunities Islamic finance accords. Each component - the financial infrastructure, the institutions, the legal, regulatory and supervisory framework and the Shariah infrastructure all have an important role in the progressive development of the Islamic financial system. The strengthening of these respective components will provide the foundations on which future sustainable progress and expansion can be realised.

While the rapid expansion of Islamic finance has been achieved in an environment of financial stability, the regulatory and supervisory agenda continue to be an important priority. Today's increasingly challenging environment of heightened risks have prompted reassessments of existing prudential rules and supervisory approaches amongst regulators to develop a dynamic regulatory and supervisory framework to achieve financial stability in all areas of the financial services sector. No less attention has been given to these issues in Islamic finance. Indeed, the work that is being undertaken by the IFSB to develop prudential, regulatory and supervisory standards and core principles that are in compliance with Shariah rules and principles represents a breakthrough in the regulation and supervision of the Islamic financial services industry.

The focus will be on regulatory approaches adopted for Islamic banking institutions that take into consideration the

context of the varying customer-banking institution relationship based on the contracts entered into that is inherent in the Islamic financial transactions. These considerations are essentially required to take into account the Shariah governance which reinforces the efforts to achieving the stability and soundness of the Islamic financial system. The presentation will also touch on areas of challenges in the formulation of the regulatory approach that arise from the multi-facet role performed by the Islamic banking institutions, and for systems in which Islamic finance operates side-by-side with the conventional financial system.

II. Objective and Regulatory Philosophy

In designing and implementing financial regulation for Islamic banking institutions, the challenge is to formulate a framework that not only takes into account the unique characteristics peculiar to Islamic banking business, but that does not put Islamic financial institutions at a comparative disadvantage and affect their competitiveness and growth potential in the overall financial system. Imperative is that the regulatory requirements need to be consistent with the injunctions of Shariah. Secondly, it needs to take into account the multi-faceted role performed by the Islamic banking institutions. Thirdly, in a dual financial system where Islamic financial institutions operate in a system side-by-side with conventional banks, including that where conventional banks may offer Islamic banking products and services through Islamic banking windows, the regulatory approach adopted needs to provide a level playing field.

Islamic banking institutions in most jurisdictions have to a large extent been governed by the same regulatory framework that is applied to conventional banking operations reinforced by the compliance to the Shariah framework. However, as the conventional banking framework is premised on an interest-based debtor-creditor relationship, the regulatory framework for conventional banking is built to assess and mitigate risks arising from loan-based financial transactions. Islamic banking is different in term of its underlying philosophy on the prohibition of interest. This in turn shapes the nature of the financial transactions that has its own risk characteristics. The specific risks associated in Islamic banking activities therefore needs to be identified to ensure its prudential regulation is adequately addressed.

It is within this context of diversity of systems and players that the regulatory approach adopted needs to ensure harmonisation and a level playing field for a competitive and robust financial system. Efforts towards achieving this objective will include the elements of greater transparencies and disclosure, a strong legal and judiciary system, reinforced by strong Shariah governance. It is in this aspect that the IFSB assumes a key role in developing prudential standards aimed at addressing issues peculiar to Islamic banking and identifying the gaps on existing regulatory and prudential standards. The IFSB represents an important catalyst that will contribute to enhancing the resilience of Islamic financial institutions in the global financial system and that will strengthen the

foundation for the progress in the development of the global Islamic financial landscape.

III. The multiple contractual relationship of Islamic banking institutions

A strong regulatory framework must have the important elements of adequate capital standards, effective risk management practices and strong governance. In building a sound prudential framework for Islamic banking, aligning regulatory capital requirements to the underlying risks requires a dichotomisation of the risk intricacies in the Islamic banking asset portfolio.

On the asset side, the Islamic banking institutions enter into different financing modes that have varying risk characteristics, ranging from the low risk sales and lease-based modes to the higher risk equity-based modes of finance. Each of these modes of finance have a distinct intrinsic characteristic dictated by its underlying Shariah principle, and thus entail different risk profiles. An equity-based finance, may for example involve higher risks and therefore attract higher capital requirement. In this regard, the challenge in formulating the risk management infrastructure in Islamic banking institutions lies in having an accurate assessment of the various risk variants underlying the alternative modes of finance to provide for their effective quantification and management.

Similarly, the liability structure of Islamic banks is characterized by two distinct categories of deposits: demand deposits which is not subject to risks associated with banking business and for which the principal is guaranteed, and investment deposits which involves risks and hence, is eligible to share the profits earned from the banking business. Given this liability structure of Islamic banking institutions, the design of the regulatory framework for Islamic banking needs to give emphasis to full financial disclosure, prudent risk management and adherence to Shariah principles. This will serve as a firewall to prevent the transmission of risks from investment deposits to demand deposits thus enhancing transparency, depositors' protection and systemic stability.

Rate of return framework

A further regulatory challenge arises from the liability structure of Islamic banking institution and the determination of a standard rate of return for account holders. Unlike conventional banking where returns are pre-determined, profit-sharing depositors of Islamic banking institutions know their returns at the maturity of the deposits. These returns are subject to the earnings of the assets that is shared between the Islamic banking institutions and the profit-sharing depositors. In the event of loss, the depositor as the capital provider will bear the losses. As the deposits in Islamic banking are for the most part are in the form of profit-sharing deposits, it places a higher degree of fiduciary risk on the management to ensure the funds are utilised in the most efficient manner.

Hence, regulators need to establish an effective rate of return framework to provide standard methodology for deriving the rate of return for depositors. Of equal importance is the need to address the information

asymmetry between the Islamic banking institutions and the depositors by enhancing the level of transparency and ensuring that depositors would receive fair returns on their investment. Within the regulatory context, the framework would provide a means of assessing the efficiency of Islamic banking institutions as well as their profitability, prudent management and fairness.

In this regard, Malaysia has introduced the Profit Equalisation Reserve in the rate of return framework. To generate rates of return that are competitive and stable, the Profit Equalisation Reserve acts as a mechanism to mitigate the fluctuation of rates of return arising from the flow in income, provisioning and total deposits. This reserve is appropriated out of the total gross income and is shared by both the depositors and the banking institution. In a dual banking environment, the ability to maximise risk adjusted return on investment and sustain stable and competitive returns is an important element for the development of a competitive Islamic banking system.

IV. Regulatory approach in a dual banking system

In a dual banking environment where Islamic banking institutions are operating side-by-side with conventional banking institutions, it is important to maintain harmonisation of the regulatory infrastructure, thus providing a level playing field for both the Islamic and conventional financial industry. The challenge lies in the development of a rigorous regulatory framework, legal and tax structure that will not position any of the financial players at a disadvantage. Of equal importance is the need to ensure that there is no opportunity for regulatory arbitrage in banking practices that makes one system more superior to the other in terms of product pricing. The Malaysian experience has a further variant of the dual banking model where conventional banking institutions are able to offer Islamic banking products and services.

In Malaysia, the Islamic financial system operates in parallel with the conventional system. The system has remained competitive and resilient as demonstrated by its growing market share and its ability to withstand adverse development. Their resilience to market vulnerabilities was demonstrated during the 1997-1998 Asian currency crisis. While the Islamic banking institutions observe similar international standards prescribed in the banking regulatory and supervisory framework and are subject to the same supervision by the Central Bank, the Islamic banking institutions are required to observe additional requirements, including observing minimum Islamic banking fund for its Islamic banking operations and maintaining an internal separation of accounting books. Further steps have been taken to require the banking institutions to disclose the fair and true value of the Islamic banking operations in the form of Balance Sheet and Profit and Loss Statements as part of the Notes to the Accounts in the principal financial statements of the banking institutions. This is to duly reflect the different risks and unique characteristics inherent in Islamic banking as compared to conventional banking. Where Islamic banking operates on a window basis,

the existence of a firewall is to ensure the strict compliance to Shariah.

Whilst the appropriate regulations and standards are vital to mitigate the risks involved, of equal importance is the oversight and monitoring of the Islamic banking institutions through effective supervision by the regulatory authority to ensure that the prudential requirements are observed. Lack of oversight, inadequate check and balances, and over exposure to risks are amongst the factors that may result in vulnerabilities to the system. The best of regulations and financial safety nets would not be able to avoid such vulnerabilities if early warning systems are not in place. To effectively perform the supervisory functions, there has to be an understanding and appreciation of Islamic banking business and operations. Supervisors therefore need to be fully equipped with the required knowledge and skills to be able to identify the risks involved in various Islamic banking transactions to effectively conduct supervisory oversight of Islamic financial industry.

V. Enhancing Shariah framework and governance

A distinct feature of Islamic banking vis-à-vis conventional banking is the requirement to set up a Shariah advisory committee within the Islamic banking institutions. The establishment of Shariah advisory committee is important to serve as a check and balance to ensure that the management and operations of the Islamic banking institutions does not deviate from the Islamic principles in the formulation of their policies. Integral to this process is to achieve "unity in diversity" of the interpretations of Shariah injunctions in the realm of finance. In this regard, the IFSB has an important role to strengthen the current initiative to achieve a greater degree of convergence and harmonisation.

Strong adherence to the Shariah is also enforced through guidelines and procedures to ensure its compliance amongst the Islamic banking institutions. Procedures for decision-making by the Shariah advisory committee of the Islamic banking institutions therefore need to be clear and transparent. The role and responsibility of the committee therefore needs to reflect their responsibility and accountability to the management and the public. Their position is comparable to the auditors of the Islamic banking institutions. Hence, the financial reporting by an Islamic banking institution is required to provide the necessary disclosure to report on the conformity of its operations with the Shariah principles. These will promote the foundations for building public confidence and assurance that the Islamic financial products are Shariah compliant.

To enhance the Shariah framework in Malaysia, the Shariah advisory council at the central bank acts as a sole authority on all Shariah matters pertaining to Islamic banking and finance. Being an apex body, the council standardises Shariah ruling on similar issues to provide greater certainty and confidence to the financial institutions and to the investors and consumers. To strengthen the Shariah and legal framework, the Malaysian Judiciary has set up a dedicated High Court to adjudicate cases involving Islamic banking and takaful in accordance with the existing

Malaysian civil laws. Any dispute, within or outside the court system that calls into question issues concerning Shariah is referred to the Shariah advisory council for guidance and clarification. Alternatively, disputes may also be referred to the arbitration centre for resolution. In this connection, Malaysia will enhance the Regional Centre for Arbitration in Kuala Lumpur to serve as a platform to deal with dispute cases on Islamic banking and finance, and to extend these services beyond our borders.

VI. Conclusion

The challenge to develop regulatory standards that remain true to Islamic core principles is an important element in the development and growth of the Islamic financial services industry. The development of an Islamic financial system that is able to contribute towards stability and balanced global growth needs for its development to be achieved in the context of a rigorous and robust legal, regulatory and supervisory regime. This is reinforced by effective supervision, strong Shariah framework and an efficient judiciary system that promotes confidence and soundness in the Islamic financial system. It is with the combined commitment and concerted efforts by regulators, the industry and market participants that these goals can be achieved.

Euromoney Conference
3 August 2004, Kuala Lumpur

"Remaking Malaysia: Investing in the New Malaysia"

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

This conference takes place at a time of strengthening economic conditions in the global and domestic economy. At the forefront of investors' minds is the sustainability of these trends. There is also much interest on the policy strategies being adopted and how Malaysia will reposition itself in this more competitive environment. This Conference has brought together key policy makers, investors, fund managers as well as leading corporate and government officials to discuss these issues.

Building on the economic success that has been achieved for more than three decades, Malaysia is now taking the opportunity to reposition its strategies to ensure the sustainability of this strong growth performance. In Remaking Malaysia, the strategy is essentially to focus on our distinct capabilities and to leverage on the areas of our strengths to secure our competitive advantage.

Let me touch briefly on the current economic developments:

- Malaysia has seen a steady and strengthening economic recovery since 2001, with the growth performance strengthening substantially in the first half of this year increasing the potential for growth for the year as a whole to surpass our earlier estimates.

- This favourable performance has been accompanied by a rebalancing of focus between external and domestic sources of growth. In the external sector, there has been a greater balance between the traditional and new markets and between the goods and services sectors.

- In the domestic sector, there has been a greater balance between the economic sectors. The strategy to have a more diversified economic structure and more extensive markets has aimed to reduce vulnerability of the economy to global shifts in demand in any specific sector or to any particular region.

- The positive fundamentals of low inflation, strong external balance, low debt and stable employment conditions have accorded policy flexibility to support the growth during this period.

Going forward, the process of rebalancing the economy to enhance the competitiveness of the economy can be expected to intensify and widen.

- There will be a greater rebalancing between the role of the public and private sectors in the economy, with the public sector activity focussed on providing the enabling environment to strengthen the role of the private sector in the economy.

- While large domestic corporations and multinational corporations will continue to be important in the economy, the role of the small and medium-scale enterprises will gain significance.

- Greater focus will be given to secure competitiveness on a more comprehensive basis in terms of other dimensions such as productivity and efficiency, labour quality, logistics, research and development, the delivery system and the supply chain.

Malaysia will also continue to leverage on our low country risks in terms of the political stability, industrial maturity and the supply of a skilled workforce.

To promote endogenous sources of growth, greater focus has been directed at promoting greater private investment, including by the small and medium enterprises (SMEs). The financial infrastructure and incentive structure will continue to be enhanced to promote investment in new sub-sectors, in particular the services, agriculture and manufacturing sectors.

On the external front, while there has been a synchronisation of growth among the major economies, there has also been some rebalancing of the relative strength of the growth among the economies. The increase in the expansion of world trade and the strengthening of labour market conditions in most of these economies suggest continued and self-sustaining growth. Meanwhile, the Asian region has shown strong growth performance amidst robust intra-regional trade. This will be mutually reinforcing for the region in expanding the cumulative domestic market of the region and thus contributing to the overall growth prospects of the region.

While growth remains strong, there are risks on the horizon. The recent moves to raise interest rates have however aimed to adjust the economic expansion to converge to more sustainable levels. Policies in a number of the major economies have now shifted from addressing a deflationary environment to a more neutral position that is aimed at removing the inflationary bias. This is in contrast to an anti-inflationary stance which would require aggressive tightening.

On the domestic front, Malaysia continues to be highly integrated with the world economy in which economic and financial developments in our major trading partners will have implications on our economy. The strengthening of our economic structure, our financial system and our macroeconomic fundamentals, particularly since the Asian crisis in 1997-1998, has raised our tolerance level for absorbing volatility, enhanced our resilience to shocks, improved the agility to adjust to change and increased our policy

flexibility to mitigate any adverse external developments on our domestic economy.

Going forward, the strong growth in manufacturing and services sectors will continue to sustain growth. The prospects for higher consumption spending is also positive. With the savings rate still high at about 35% of GNP and the rising incomes, Malaysia has the potential to promote a higher level of consumption without undermining the potential for financing of private investment from domestic sources. The higher consumption has also not created risks of increased household indebtedness which has remained within prudential levels at less than 60% of GDP.

Capital spending continues to gain momentum both in domestic and export oriented activities. Domestic companies are also forging strategic alliances as part of the strategy to expand to new export markets and leverage on new technologies. The on-going capacity expansion and more competitive business environment will keep inflation low thereby allowing domestic interest rates to continue to remain low for sometime to come. Malaysia's trade and investment links with Asia, particularly with the large economies in the region, is also expected to strengthen further.

There also continues to be steady inflows of foreign direct investment. In addition to sustained inflows into the manufacturing and oil and gas sectors, these flows have become more broad based with higher shares of new flows shifting towards higher value-added activity in the services sector. This structural change in FDI flows reflect the changing opportunities Malaysia accords with the services sector now gaining significance as an engine of growth. The new inflows have also tended to be low import content and higher value added. The FDI in services sector has also been increasingly broad based. A number of regional and global business processing centres and other regional facilities have been set up including the OHQs, regional offices, international procurement centres and regional distribution centres.

As part of the Government policy commitment to improve the delivery system and reduce the cost of doing business, the Central Bank has undertaken a progressive liberalisation of domestic rules and regulations to reduce the cost of doing business. An area of focus has been the rules governing the foreign exchange transactions. Reducing cost of managing risks associated with such transactions include the recent liberalisation of rules on foreign currency accounts, interest rates swaps and hedging. To broaden and deepen our capital markets, the multilateral agencies and multinational corporations are now allowed to issue bonds in Malaysia. Going forward, Malaysia will continue to undertake further liberalisation while balancing the need to accord flexibility and choices to businesses with the macroeconomic objectives of ensuring stability in financial markets. Ensuring such long-term stability that facilitates planning and investment decisions has been an important part of maintaining our competitive position.

In the development of our financial sector, the banking sector continues to be the

pillar of the financial system and is now at its strongest position with high level of capitalisation, improving asset quality and stronger profitability. Policy initiatives to strengthen the banking system, including in the areas of regulatory and supervisory frameworks, risk management, corporate governance and best practices in transparency and disclosure have contributed to strengthen the system further. These have been complemented with initiatives to deepen the bond and equity markets, resulting in a more diversified financial infrastructure.

Another priority area has been the development of the Islamic financial system as a viable component of the financial system. With more than two decades experience in developing Islamic finance, Malaysia today has a comprehensive Islamic financial system with all the core components of banking, takaful and the money and capital markets, and supported by a strong legal and supervisory framework. The assets mobilised by the Islamic banking sector have increased significantly to account for about 10% of the total assets of the banking system. In the Islamic capital market, outstanding Islamic bonds amounted to about 45% of the total outstanding bonds.

As our domestic financial system develops and strengthens, Malaysia has gradually moved towards a more deregulated and liberalised environment. In the regulation of the banking institutions, a balance will be made between promoting competition and innovation, and maintaining prudence and stability. Regulations will continuously be reviewed to provide greater operational flexibility for banking institutions without compromising prudential objectives. The introduction of the new interest rate framework reflects the move to promote more efficient pricing in the banking system. As progress is achieved in enhancing the capacity and capability of domestic institutions, the financial sector will continue to be gradually liberalised. Moving forward, further deregulation will be undertaken to simplify and liberalise regulations and administrative rules for businesses. To ensure stability as regulations are lifted, leveraging on technology to improve data monitoring systems have enhanced the ability to monitor developments to assess any emerging risks to the system.

During this period of strong fundamentals and rising potential for economic expansion, Malaysia has the flexibility to introduce measures not only to support growth but also to improve the quality of the growth and its long term sustainability. This includes significant investment in education and according priority towards achieving socio-economic stability. Overall, a balanced and holistic approach to economic management is aimed to ensure the foundation for a strong economy and its competitive position in the global economy.

Calendar of Events
April - June 2004

15 April 2004
The Governor delivered a keynote address at the Risk Management Seminar on the new Basel II Capital Accord, in which she said that Malaysia would adopt four key principles in a two-phased approach to implementing Basel II for Malaysian banks, beginning in January 2008. The principles are: the need to accommodate capacity building efforts; a more flexible timeframe; an emphasis on strong business justification; and an enhanced supervisory methodology.

21 April 2004
The Bank released the 2003 Insurance and Takaful Annual Reports which provide an analysis of the insurance and takaful industries' performance and developments in 2003.

23 April 2004
The Bank introduced the New Interest Rate Framework to enhance the effectiveness of monetary policy. The new framework is designed to facilitate the transmission of changes in the policy rate, known as the Overnight Policy Rate (OPR), to the other market rates and ultimately, to key macroeconomic objectives. The new framework would also promote more efficient pricing by banking institutions.

14 May 2004
The Governor delivered a keynote address at the Malaysian Banking Summit 2004, in which she envisaged that three types of banking institutions would emerge to meet the future demands of the economy, which are:

- Large Malaysian banks with nationwide, regional and international presence that are able to compete with global financial players;
- Banking institutions with nationwide presence that are able to offer a broad range of financial products and services; and
- Specialist niche players delivering specialised value added products and services for specific segments of the market.

17 May 2004
The Minister of Finance announced the appointment of Datuk Zamani Abdul Ghani as the new Deputy Governor of Bank Negara Malaysia replacing Dato' Mohd. Salleh Harun who retired.

21 May 2004

The Bank announced the third issuance of Bon Simpanan Merdeka amounting to RM500 million which was issued on 1 July 2004. The bond provides an additional savings instrument to senior citizens, Malaysian Armed Forces personnel who are on retirement, as well as Malaysian citizens who have retired on medical grounds. In view of the overwhelming subscription from a large number of investors, a change in the allocation approach was made to provide the opportunity to as many investors as possible.

26 May 2004

The Bank announced that the Malaysian economy recorded an impressive growth of 7.6% in the first quarter of 2004, which was the highest since the third quarter of 2000. The growth was broad-based across all sectors. The key contributors were the manufacturing and services sectors. The manufacturing sector expanded by 12.5%, contributing 3.8 percentage points to the GDP.

The Monetary Policy Statement stated that the underlying fundamentals would continue to accord flexibility for monetary policy to support stronger economic activities, without creating inflationary pressures. Interest rates could remain low for some time to come, to support the growth momentum. Hence, the overnight policy rate (OPR) would remain unchanged at 2.70%.

27 May 2004

The Bank announced it has approved the application of Kuwait Finance House to establish a full-fledged Islamic bank in Malaysia. This followed the announcement made earlier that up to three new Islamic banking licences would be issued to qualified foreign Islamic banking players, as part of the move to bring forward the liberalisation of the Islamic banking industry.

18 June 2004

The Bank signed a Bilateral Payments Arrangement (BPA) Agreement with Bank Mandiri, Indonesia, to facilitate the promotion of trade and establishment of correspondent banking relationships between Malaysia and Indonesia. Under the BPA, a settlement arrangement is established whereby the net trade balance between the two countries are settled in an agreed currency on a periodic basis.