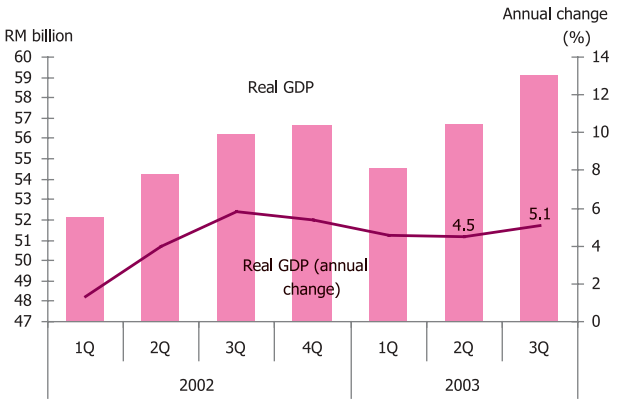
Economic and Financial Developments in the Malaysian Economy in the Third Quarter of 2003

OVERVIEW

Stronger growth momentum in the third quarter

The Malaysian economy expanded at a more rapid pace of 5.1% in the third quarter of 2003 from 4.5% in the second quarter. The growth has been broad based, both in terms of expenditure and production components. Strong economic fundamentals and the comprehensive public sector response to uncertainties in the global economy in the early part of the year has enabled the economy to benefit from the more favourable external environment in the third quarter. The strong private sector response to the pro-active Government measures and a low interest rate environment has contributed to the strengthening of the growth momentum.

Stronger real GDP growth in 3Q 2003



Growth in domestic demand was driven mainly by the private sector. Private sector activity strengthened with both consumption and investment picking-up momentum as a result of the cumulative effects of low interest rates, the Government measures, which resulted in higher disposable incomes and increased access to financing, and the beneficial impact of higher commodity prices on rural incomes. Other important factors supporting private sector activity was the growth in productivity and rising real wages amidst stable labour market conditions. The positive response to policies and the improved external outlook led to increased consumer and business confidence during the quarter. Private consumption grew strongly by 5.4% during the quarter. The more favourable economic environment and higher capacity utilization in the manufacturing sector stimulated the growth in private investment. As a result, growth in gross fixed capital formation accelerated to 3.2%.

Despite public consumption expenditure being sustained at a high level, the fiscal deficit declined in the third quarter as a result of improved revenue performance following the overall strengthening of the economy.

All sectors of the economy expanded markedly, except mining. Recovery in tourism, together with stronger consumer confidence, resulted in the sector recovering completely from SARS and the geopolitical uncertainties in early 2003.

The stronger expansion in manufacturing of 8.5% was stimulated by more buoyant domestic consumption and higher production for export. Capacity utilization remained high across both

domestic- and export-oriented industries. Generally, improved business confidence and a more optimistic outlook for global growth have resulted in further inflows of new foreign direct investment into the manufacturing sector in the third quarter.

Agriculture registered its fifth quarter of strong expansion as further increases in commodity prices stimulated robust production of both palm oil (+15.2%) and rubber (+17%). While crude oil production rose, lower output of natural gas from a temporary shut down of a gas field led to a marginal decline in the mining sector.

Stronger economic growth in the third quarter was achieved with low inflation. Consumer prices remained benign, rising by 1%. A combination of excess capacity, rising productivity and more competitive pricing of goods and services contained pricing power despite strengthening demand. Latest indicators on property prices, available to end-June, show only marginal increases, mainly for landed properties in choice locations. The overall price index is still at about levels in 1997-98.

The contribution from the external sector remained strong during the third quarter. The increase in reserves by US$3.7 billion to US$40.7 billion at the end of the quarter continued to accrue largely from long-term inflows associated with trade and investment activities. Net inflows of portfolio capital also contributed to the increase, though the flows only rose at a slightly higher rate since end-September. International reserves have risen further to US$43.6 billion as at 31 October, sufficient to finance 6.9 months of imports and is 4.7 times short-term external debt.

Preliminary data published indicates that the trade surplus declined to RM15.2 billion during the quarter as both gross exports (-3.1%) and gross imports (-5.7%) declined. The trade data is currently being reviewed by the Department of Statistics (DOS) as the changeover from the manual processing system to the Electronic Data Interchange System (EDIS) has given rise to some exclusions. DOS will release the data when the review is completed.

In the financial account, a notable development is the sustained foreign direct investment. New long-term equity inflows doubled during the third quarter, with foreign direct investment being channeled mainly into the services sector, particularly into financial and business services, wholesale and retail trade and the transport sector. Foreign investments in the manufacturing sector were mainly for semiconductor and petroleum-related activities.

The ringgit exchange rate continues to be well supported by the strong level of foreign exchange reserves, low inflation, continued surpluses in the current account, low external debt as well as a strong and resilient banking system. Notwithstanding recent developments in the foreign exchange markets, it is assessed that the ringgit remains at fair value. The peg provides stability and predictability, facilitating trade and investment activities and thus remains an integral part of macroeconomic management in Malaysia.

Monetary policy supported robust growth

Monetary conditions mirrored the strengthening of growth. Demand for credit rose, non-performing loans declined and the financial system was strongly supportive of private sector

activity. Loans disbursed by the banking system rose at an annual rate of 14.6%. Compared with the second quarter, higher amounts were disbursed to SMEs, the household sector and to large corporations. Loans disbursed to the businesses during the quarter increased by 17%.

As a consequence of the higher disbursements, total loans outstanding increased at an annual rate of 4.7% at end-September. Loans outstanding to the SMEs, which accounted for 15.6% of all outstanding loans and 31.5% of total loans outstanding to businesses, rose more rapidly by 7%. In the first nine months, outstanding loans to the SMEs expanded by RM4.8 billion. Overall, financing provided by the banking system through extension of loans and its holdings of PDS expanded by 5.7% as at end-September. Total gross private sector financing raised through the banking system and from the capital market increased significantly by 13.9% during the quarter.

The increase in all three monetary aggregates was also reflective of the significantly improved consumer and business sentiments. While stronger expansion in M1 (11.9%) reflected increased demand for liquidity from consumers, businesses and higher trading in the stock market, higher growth in M3 (9.2%) reflected the increase in direct lending by the banking system and an expansionary external sector.

Despite the stronger demand for loans, average lending rates continued to decline following the 50-basis point reduction of BNM's policy rate in May 2003 as well as the more competitive banking environment. Notwithstanding larger capital inflows, BNM's liquidity operations ensured that rates remained stable. There remains adequate instruments to facilitate sterilization operations. As a result, growth in money supply has remained consistent with the higher level of economic activities.

The profitability of the banking sector remained strong during the quarter while the better economic conditions saw improving asset quality. The banking system recorded a higher gross operating profit of RM3 billion in the third quarter due mainly to higher income, though interest expenses on deposits and operating costs were also lower.

The net NPL ratio (6-month basis) declined to 6.5% at end-September 2003 (9% on a 3-month basis). The level of NPLs for the business sector, in particular continued to record improvements. The largest decline was observed in NPLs for community, personal and social services sector, and financial services sector following the implementation of a number of restructuring exercises. NPLs for the household sector remained manageable at 8.2%.

Forward-looking indicators point to sustained strong growth

Prospects for the global economy for the remaining part of 2003 and into 2004 are turning significantly more positive. The US economy rebounded strongly in the third quarter, with rising job creation and investments and a consequent decline in the unemployment rate. This development is expected to have a positive impact in sustaining US private consumption. Stronger evidence of increases in investment is indicative of a more sustainable recovery in global growth. Encouraging trends have also emerged in Japan and Europe.

This more positive external environment will reinforce stronger domestic demand. Greater

consumer and business confidence is expected to reinforce the momentum of growth in private consumption and investment while the public sector gradually consolidates.

The major indicators continue to support sustained growth in the near to medium term. The Malaysian Institute of Economic Research Consumer Sentiments Index, which rose by 5.9 points to 112.8 points in the third quarter, reflects rising consumer optimism. Similarly, the outlook for investment, especially private investment, also shows an upward trend. Among the forward-looking indicators, the rising trend in loan applications showed sustained demand for finance to expand business activities. In addition, the economy continues to enjoy the positive effects of the earlier stimulus measures taken by the Government. More importantly, the improvement in sentiment is supported by strong underlying fundamentals that not only provide stable conditions for future growth but also allow risks to remain contained. The outlook for inflation remains low and stable while trade and long-term investment flows have contributed a significant share to the increase in international reserves. In addition, the banking system is well capitalized with NPLs on a declining trend, suggesting a more resilient banking sector. Notwithstanding the positive outlook and relatively low risks, the Government has the flexibility to implement preemptive action in the event of adverse external developments.

While current circumstances support growth exceeding earlier forecasts, it will take some time before the gap between potential and actual output narrows. Under these circumstances, the current accommodative monetary policy will be maintained to support the growth momentum.

DEVELOPMENTS IN THE ECONOMY

International Economic Environment

Global environment strengthens. Business investment turns positive in the US while Asian growth recovers as SARS contained.

The global economic environment strengthened further in the third quarter. The US economy expanded significantly by 7.2% during the quarter (2Q: 3.3%), its highest quarterly growth recorded in two decades. Major contributory factors were the sharp gains in consumer spending, residential and non-residential fixed investments and exports. The Japanese economy exhibited further signs of improvement as reflected in the strong recovery of private investment and exports, while the pace of decline in prices continued to moderate. However, recovery in much of Europe remained constrained by structural rigidities despite improvement in business sentiment.

Reflecting a more optimistic outlook on the international environment, the global equity markets showed stronger performance, particularly in the technology-related sectors. In the foreign exchange market, the G7 endorsement of flexibility in currency movements caused volatility in the market and a weaker US dollar. Going forward, the sustainability of the global economic recovery will hinge on the strength of expansion in business investment, the extent of fiscal and monetary stimulus in the major industrialised countries as well as orderly adjustments in the US current account and fiscal imbalances.

Industrial Countries:
Real GDP growth showed improved performance

	Yearly	Quarterly		
	2002	2Q '03	3Q '03	Contributing factors
US[1/]	2.4	3.3	7.2	Strong consumer spending, business investment and export growth.
UK	1.8	2.0	1.9	Robust consumer spending and sustained government expenditure.
Germany	0.2	-0.7	-0.2	Weak industrial output and labour market conditions but improved consumer and business sentiment.
Japan[1/]	0.2	3.5	2.2	Improvement in exports and capital spending.

1/ annualised basis

In the **Asian** region, following the containment of the Severe Acute Respiratory Syndrome (SARS) by the end of the second quarter, regional growth gained strength in the third quarter. Growth was supported mainly by stronger export performance. In addition, most of the previously SARS-affected countries registered a recovery in domestic consumption and tourist arrivals. The People's Republic of China (P. R. China) registered the highest real GDP growth (9.1%), while growth turned positive in Chinese Taipei and Singapore.

Overall, growth in the third quarter was reinforced by strong export performance on the back of continued strong domestic demand, benign inflation and low interest rates. Inflation in P. R. China continued to edge up, albeit marginally, due mainly to increased demand for raw materials. In contrast, deflationary pressures in Hong Kong China and Chinese Taipei persisted, as domestic demand conditions remained soft. In most of the regional countries, there were further declines in short-term interest rates and strengthening of international reserves positions.

Given expectations of further improvements in external and domestic conditions, growth forecasts for 2003 were raised in P. R. China,

Hong Kong China and Thailand. In contrast, the growth forecast for Korea was lowered due to political uncertainty and weakness in domestic consumption and investment activities.

Regional Countries: Real GDP growth improved

	Yearly	Quarterly		
	2002	2Q '03	3Q '03e/	Key contributing factors
P. R. China	8.0	6.7	9.1	Robust investment activity and consumption spending.
Korea	6.3	1.9	2.7	Export growth more than offset weak consumption and investment expenditures.
Singapore	2.2	-3.8	1.7	Expansion in manufacturing, particularly electronics and pharmaceuticals.
Chinese Taipei	3.5	-0.1	4.2	Supported by strong export performance.
Indonesia	3.7	3.8	3.9	Broad-based improvements in domestic and external conditions.
Philippines	4.6	4.5	4.0	Recovery in agriculture sector partially offset weakness in manufacturing sector.

e/ Estimate

Developments in the Malaysian Economy

Higher growth in the third quarter was underpinned by strong private sector activity

Growth was markedly stronger in the third quarter with real GDP expanding by 5.1% (2Q 2003: 4.5%). Aggregate domestic demand strengthened, underpinned by higher private sector spending as pro-growth measures introduced by the Government and buoyant commodity prices supported the recovery of the services sector and strengthened private consumption.

Domestic demand strengthened in the third quarter, benefiting from low interest rates and earlier measures to increase disposable incomes of households and improve access to funding to meet the financing needs of industries and the SMEs. Firm commodity prices continued to raise rural incomes and consumption. Stable labour market conditions and a more optimistic outlook regarding prospects for global economic growth led to a further improvement in consumer and business confidence. Overall, private sector demand strengthened.

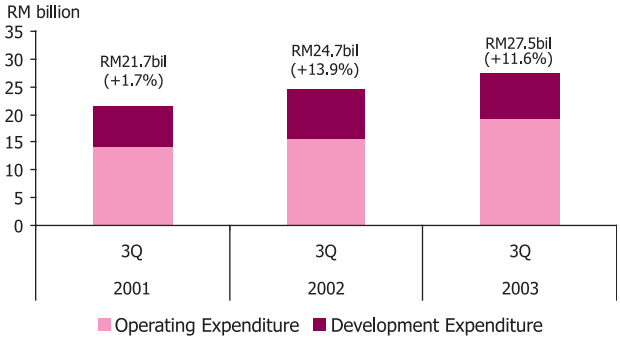
Following recovery from SARS-related concerns, private consumption recorded a strong growth of 5.4% (2Q 2003: 3.4%) during the quarter. Major consumption indicators, including the expansion of monetary aggregates, especially M1, loans disbursed to households and consumer spending on credit cards, pointed to growing consumer optimism. This was reflected in the

GDP by Expenditure Components (at Constant 1987 prices)

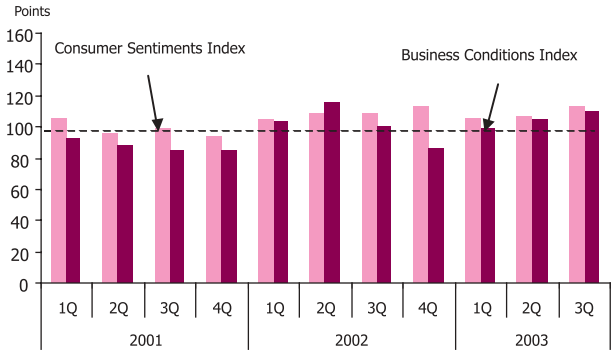
	2002		2003		
	3Q	4Q	1Q	2Q	3Q
	Annual change in %				
Aggregate domestic demand (excluding stocks)	6.1	6.6	5.9	3.0	3.5
Consumption	7.8	5.1	6.9	4.3	3.6
Private sector	*4.2*	*4.6*	*4.3*	*3.4*	*5.4*
Public sector	*19.2*	*6.5*	*18.9*	*7.2*	*-1.6*
Gross Fixed Capital Formation	2.8	10.0	3.8	0.4	3.2
Exports of Goods and Services	11.2	7.2	1.9	0.2	-5.0
Imports of Goods and Services	15.6	8.1	1.7	-2.9	-5.1
GDP	**5.8**	**5.4**	**4.6**	**4.5**	**5.1**

Source: Department of Statistics, Malaysia

Federal Government's spending remained high



Growing consumer and business confidence



Malaysian Institute of Economic Research (MIER) Consumer Sentiments Index, which rose by 5.9 points to 112.8 points in the third quarter. Public consumption also remained high, due mainly to the higher expenditure on emoluments and supplies and services.

An important development supporting higher private sector activity was the significant improvement in investment. Gross fixed capital formation expanded by 3.2% in the third quarter (2Q 2003: 0.4%). Private sector investment activities rose amidst stronger financial positions of corporations and higher capacity utilisation rates. Business sentiments turned more positive during the quarter. The MIER Business Conditions Index increased by 4.9 points to 109.8 points, reflecting improved results in most components including output, domestic orders and inventory levels. Other major private investment indicators, including sales of commercial vehicles and loan disbursements to the manufacturing and construction sectors, also pointed to stronger recovery of investment activities. Meanwhile, development expenditure of the Federal Government continued to remain high, particularly on health, public utilities and agriculture and rural development.

Sectoral Developments

Growth broad based and balanced across the sectors

Growth in the third quarter was broad based, characterised by the rapid recovery in the services sector after the transitory impact of SARS and continued strong expansion in the manufacturing and agriculture sectors.

Quarterly GDP by Kind of Economic Activity at 1987 Prices

	2002		2003		
	3Q	4Q	1Q	2Q	3Q
	Annual change in %				
Agriculture	8.3	5.5	3.4	10.4	6.2
Mining	7.9	7.1	4.5	11.1	-0.7
Manufacturing	7.3	5.7	5.9	6.5	8.5
Construction	2.6	0.5	1.2	1.4	2.4
Services	3.4	4.6	4.5	2.9	4.2
Real GDP (Annual chg.)	**5.8**	**5.4**	**4.6**	**4.5**	**5.1**
Real GDP (Preceding chg.)	**3.6**	**0.7**	**-3.8**	**4.1**	**4.2**

Source: Department of Statistics, Malaysia

Recovery in the services sector

The **services sector** rebounded to expand by 4.2% (2Q: 2.9%) following the improvement in consumer sentiment as well as

Value Added in the Services Sector

	2002		2003		
	3Q	4Q	1Q	2Q	3Q
	Annual change in %				
Intermediate Services	**2.5**	**3.8**	**4.1**	**4.3**	**6.0**
Transport, storage and communications	2.8	3.3	4.8	4.2	5.5
Finance, insurance, real estate and business services	2.3	4.0	3.8	4.4	6.4
Final Services	**4.1**	**5.2**	**4.7**	**1.9**	**3.1**
Electricity, gas and water	2.2	4.3	7.3	7.3	5.2
Wholesale and retail trade, hotels and restaurants	3.7	2.6	3.2	-2.0	1.7
Government services	6.0	9.3	5.9	6.9	4.2
Other services	4.0	6.9	5.0	1.6	3.6
Total Services	**3.4**	**4.6**	**4.5**	**2.9**	**4.2**

Source: Department of Statistics, Malaysia

the revival in tourism and travel related-sectors from the effects of SARS, aided by the positive measures introduced in the Economic Package. Of significance, growth in the wholesale and retail trade, hotels and restaurants sub-sector turned around to increase by 1.7% (2Q: -2%). Against the preceding quarter, the sector grew by almost 10%. The recovery was broad based across retail and distributive activities. Hotel businesses also recovered rapidly as monthly tourist arrivals doubled from 459,300 in April to 943,500 by September 2003.

Similarly, growth in the transport, storage and communications sub-sector strengthened further. Air travel, especially the passenger segment, which had been adversely affected in the previous quarter, saw a marked improvement, with passenger traffic increasing by 30% over the preceding quarter. Growth was also supported by sustained port activities as container cargo handled at the two major ports rose by 14.5%. In the telecommunications sub-sector, the increase in the subscriber base as well as sales of new products in the cellular segment sustained the strong growth momentum.

Growth in the finance, insurance, real estate and business services sector was stronger as the reduction in interest rates and additional funds provided under the Economic Package led to higher bank lending. The robust insurance activities and the strong return of interest in the stock market provided further support to the sector. The Government services sub-sector expanded moderately, while growth in the utilities sub-sector was underpinned by strong demand for electricity, particularly from the commercial and industrial sectors.

Growth strengthened further in the manufacturing sector

Growth in the **manufacturing sector** strengthened further to 8.5% in the quarter, supported by higher growth in both the domestic-oriented (6.1%, 2Q: 3.3%) and export-oriented industries (12.1%, 2Q: 10%). The overall capacity utilisation rate was higher at 86% (2Q: 83%), with both the export- and domestic-oriented industries operating at 88% and 82% respectively (2Q: 84% and 82% respectively).

Selected Indicators in the Services Sector

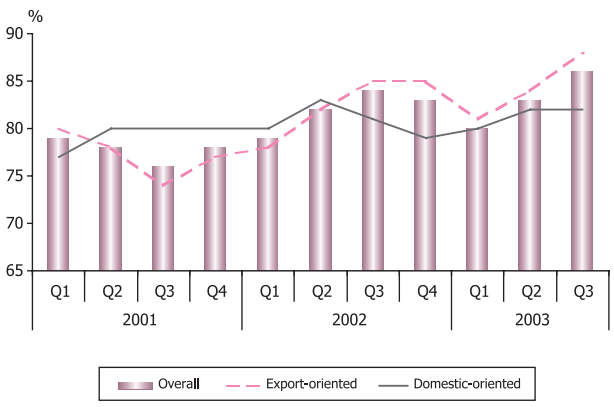
Indicators	2003 1Q	2Q	3Q	2Q	3Q
	ann. chg. (%)			preceding chg. (%)	
MRA Retail sales	-0.1	-2.9	6.4 f	n.a.	n.a.
Tourist arrivals	-6.5	-51.6	-24.2	-40.2	46.7
Disbursement of consumption credit	3.1	1.9	7.4	0.5	9.2
Total passenger traffic in all airports in Malaysia	12.5	-15.9	2.1	-21.3	29.8
	levels			preceding chg. (levels)	
MIER Retail Survey Index	78.1	96.3	125.0	+ 18.2	+ 28.7
MIER Hotel Operators Index	101.5	81.0	139.0	- 20.5	+ 58.0
MAS passenger load factor (%)	67.3	56.0	73.0	-11.3	+ 17.0

Nota: MRA refers to Malaysia Retailers Association; MIER refers to Malaysian Institute of Economic Research and MAS refers to Malaysia Airlines

f Forecast

Source: Various sources

Capacity Utilisation in the Manufacturing Sector



Performance of the Manufacturing Sector

	2002		2003		
	3Q	4Q	1Q	2Q	3Q
	Annual change in %				
Value Added (Constant Price)	**7.3**	**5.7**	**5.9**	**6.5**	**8.5**
Overall Production	**8.5**	**6.7**	**7.6**	**8.2**	**10.6**
Export-oriented industries	**11.2**	**8.9**	**8.0**	**10.0**	**12.1**
of which :					
- Electronics	20.5	12.5	8.6	7.0	14.7
- Electrical	0.1	-4.2	-4.3	-7.6	-12.4
- Textiles & wearing apparel	-7.1	4.4	0.8	2.3	3.0
- Chemicals and chemical products	9.8	13.1	16.4	23.8	20.8
- Off-estate processing	17.8	12.0	4.5	27.3	17.1
- Rubber products	7.1	5.5	9.6	14.3	26.6
- Wood and wood products[1/]	-3.1	1.0	4.3	-0.4	1.4
Domestic-oriented industries	**1.5**	**0.6**	**6.4**	**3.3**	**6.1**
of which :					
- Transport equipment	3.2	-7.9	-6.6	-13.5	-2.6
- Fabricated metal products	-1.3	-1.9	3.8	7.9	-0.7
- Iron & steel and non-ferrous metal	-2.0	4.7	16.7	0.8	13.8
- Non-metallic mineral products	4.3	1.3	10.0	11.4	9.2
- Petroleum products	-1.7	-6.0	1.9	17.5	-6.1
- Food	3.5	10.3	5.5	7.3	16.0
Total Manufactured Exports	**12.7**	**5.1**	**1.7**	**1.3**	**-8.2**
- Electronics	21.6	4.4	-5.8	-4.3	-19.5
Semiconductor	48.9	36.6	27.2	22.4	-11.0
Electronic equip. & parts	3.0	-18.3	-28.3	-25.2	-27.9
- Electrical products	-4.0	-8.3	-7.4	-5.2	-4.8
Consumer electrical products	-9.7	-9.7	-12.5	-17.7	-10.7
Industrial & commercial electrical products	-5.8	-19.5	-14.2	-0.2	-7.3
Electrical industrial machinery & equipment	9.8	11.0	4.1	4.6	6.7
Household electrical appliances	11.5	81.7	78.7	39.9	18.2
- Wood and wood products	23.3	19.1	13.2	5.5	-2.3
- Furniture & parts	10.1	7.4	8.9	5.1	3.3
- Textiles, clothing & footwear	4.5	5.0	8.4	3.3	-1.9
- Optical & scientific equipment	10.1	4.8	19.1	15.7	1.1
- Chemical and chemical products	23.5	34.4	33.9	22.6	18.7
- Petroleum products	-4.1	29.7	67.3	23.8	5.6

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

Growth in the export-oriented industries was supported mainly by strong expansion in the off-estate processing, rubber products, chemicals and semiconductor industries. In particular, output of the rubber products industry expanded strongly by 26.6%, benefiting from higher demand for surgical gloves. The semiconductor industry also continued to perform well, supported by improved global demand, particularly from Asia and Europe. The chemical products industry continued to record double-digit growth underpinned by higher output of plastic products and industrial chemicals. In the domestic-oriented industries, the higher output expansion was driven largely by the strong expansion in construction-related materials industries in line with the pick-up in the construction sector as well as food and paper products industries.

Sustained strong growth in agriculture, marginal decline in the mining sector

The **agriculture sector** continued to register the fifth consecutive quarter of strong growth (6.2%), attributed to robust increases in palm oil and rubber production. Rising prices of most of the major agricultural commodities, ranging between 5 to 17%, motivated higher production

Performance of the Agriculture Sector

	2002		2003		
	3Q	4Q	1Q	2Q	3Q
	Annual change in %				
Value Added (at 1987 prices)	**8.3**	**5.5**	**3.4**	**10.4**	**6.2**
Production[1/]					
Of which:					
Crude palm oil	13.0	1.6	0.4	27.3	15.2
Crude palm kernel oil	1.4	0.9	-5.2	28.7	20.6
Rubber	5.1	17.8	16.6	21.3	17.0
Saw logs	15.9	22.8	4.0	-2.6	-9.2
Cocoa	-28.2	35.2	71.5	14.7	-16.7
Exports (RM million)	**42.2**	**49.3**	**41.8**	**33.6**	**29.3**
Of which:					
Palm oil					
('000 tonnes)	12.4	12.1	9.3	15.3	36.4
(RM/tonne)	39.7	46.9	41.4	25.3	7.4
(RM million)	57.0	64.7	54.6	44.4	46.5
Palm kernel oil					
('000 tonnes)	-5.0	15.1	-33.9	7.1	93.9
(RM/tonne)	31.0	38.9	51.0	17.2	1.3
(RM million)	24.5	59.8	-0.2	25.6	96.4
Rubber					
('000 tonnes)	19.4	6.4	13.4	2.0	1.0
(Sen/kilogramme)	36.5	57.8	57.6	40.0	17.2
(RM million)	63.0	67.9	78.7	42.8	18.4
Sawn timber					
('000 cu.metres)	-0.7	4.9	7.8	6.7	8.0
(RM/cu. metre)	8.2	1.8	12.1	9.9	4.5
(RM million)	7.5	6.8	20.8	17.3	12.9
Saw logs					
('000 cu. metres)	2.4	12.9	19.5	32.8	-6.9
(RM/cu. metre)	33.8	31.8	18.9	5.6	-9.6
(RM million)	37.0	48.8	42.1	40.3	-15.8
Cocoa beans					
('000 tonnes)	8.0	71.2	51.7	-38.0	-74.3
(RM/tonne)	43.3	70.3	62.9	37.2	11.9
(RM million)	54.7	191.5	147.2	-14.9	-71.3

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

Performance of the Mining Sector

	2002		2003		
	3Q	4Q	1Q	2Q	3Q
	Annual change in %				
Value Added (at 1987 prices)	**7.9**	**7.1**	**4.5**	**11.1**	**-0.7**
Production					
Of which:					
Crude oil and condensates ('000 barrels)	9.1	7.4	2.3	11.7	1.8
Natural gas (net) (million standard cubic feet)	8.0	9.3	8.2	17.3	-6.2
Exports (RM million)	**5.8**	**29.3**	**50.9**	**38.7**	**25.9**
Of which:					
Crude oil					
('000 tonnes)	18.3	5.5	4.2	0.3	13.7
(US$/barrel)	1.3	37.2	61.3	15.9	6.9
(RM million)	19.8	44.7	68.0	16.2	21.6
Liquefied natural gas					
('000 tonnes)	-0.7	12.9	6.9	41.0	10.3
(RM/tonne)	-4.4	6.6	28.8	33.3	8.9
(RM million)	-5.1	20.4	37.8	88.0	20.1

activity, particularly among the smallholders. Following the strong growth in the previous quarter, the mining sector recorded a marginal decline, due largely to lower production of natural gas. Crude oil production recorded a small increase.

After the strong growth of 27.3% in the previous quarter, crude palm oil production continued to increase by 15.2%, or a monthly average output of 1.3 million tonnes. The growth was underpinned by higher yields as reflected by the average oil extraction rate of 19.88% during the quarter (2Q 2003: 19.63%) as well as increased mature area, especially in Sabah. Rubber production surged further by 17% as continued rise in rubber prices, which averaged above 400 sen per kilogramme by September 2003, induced intensive tapping activity among the smallholders. Consequently, rubber smallholders accounted for about 89% of total national production during the quarter (2002: 85%).

Value added in the **mining sector** declined during the third quarter, albeit marginally by 0.7%, due mainly to lower natural gas production. Output of natural gas was affected by a temporary shutdown of a gas field for maintenance purposes. Meanwhile, crude oil production (including condensates) increased further by 1.8% to 720,390 barrels per day during the quarter.

Construction activity benefiting from the Economic Package

In the **construction sector**, the growth momentum picked up gradually in the third quarter (2Q 2003:1.4%). In particular, the residential sub-sector benefited from the Government incentives provided in the Economic Package as well as the on-going construction works on a large number of housing projects that were launched in the previous year. The stamp duty waiver on selected categories of houses, reduction in interest rates, competitive loan packages offered by financial institutions and intensive promotional activities by housing developers in the major towns encouraged demand for residential property. However, construction activity in the public sector was lower due to lower expenditure on educational facilities.

Construction Indicators

	2002		2003		
	3Q	4Q	1Q	2Q	3Q
	Annual change in %				
New sales and advertising permits	4.2	-11.4	-24.5	-16.7	14.9
Housing approvals	-25.5	-32.3	-30.7	0.8	19.3
Production of construction-related materials	1.4	2.8	13.0	6.5	11.3
Loans approved for construction	5.6	69.6	20.0	-44.3	16.6
Imports of construction materials & mineral products	32.2	8.7	4.0	-19.3	-23.4*

* *July-August '03*

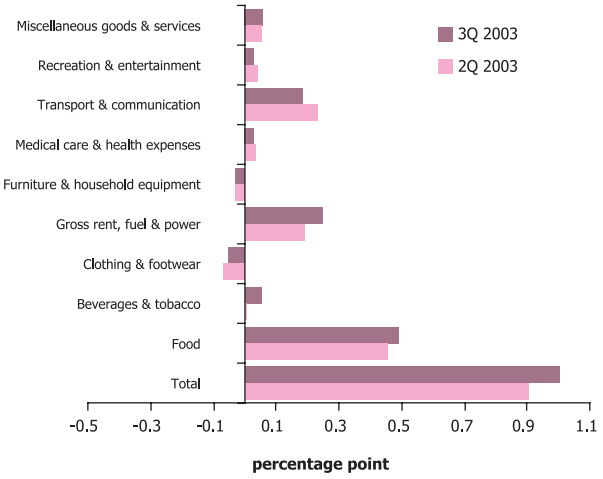
Source: Ministry of Housing and Local Government
Department of Statistics, Malaysia

Inflation remained low

Inflation, as measured by the annual change in the Consumer Price Index (CPI), remained

low at 1% during the third quarter of 2003 (2Q 2003: 0.9%). Reflecting higher consumer spending, price increases for food and gross rent, fuel and power were higher in the third quarter compared with the previous quarter. Meanwhile, price increases for beverages and tobacco was also higher following the introduction of higher import and excise duties on alcoholic beverages and tobacco product. Nonetheless, higher prices for these products were offset by declines and lower price increases for other consumer products and services.

Contribution to Inflation



Source: Department of Statistics, Malaysia

Labour market conditions remained stable

Supported by growth in productivity, labour market conditions continued to remain stable. In the manufacturing sector, based on data for July and August 2003, labour productivity, as measured by real sales value of products per employee rose by 4%, exceeding the 2.4% increase in real wage per employee. Retrenchment during the quarter was lower (5,328 persons; 3Q 2002: 5,549 persons and 2Q 2003: 6,677 persons).

Stable Labour Market Conditions



Trade surplus remained favourable

Preliminary data published indicates that the trade surplus declined to RM15.2 billion during the quarter as both gross exports (-3.1%) and gross imports (-5.7%) declined. The trade data is currently being reviewed by the Department of Statistics (DOS) as the changeover from the manual processing system to the Electronic Data Interchange System (EDIS) has given rise to some exclusions. DOS will release the data when the review is completed.

Trade Account

	2002		2003		
	3Q	4Q	1Q	2Q	3Q
	Annual change in %				
Gross Exports	14.3	9.7	8.0	6.0	-3.1
Manufacturing	12.7	5.1	1.7	1.3	-8.2
Agriculture	42.2	49.3	41.8	33.6	29.3
Minerals	5.8	29.3	50.9	38.7	25.9
Gross Imports	19.6	8.6	2.6	-5.0	-5.7
Capital goods	17.7	0.4	-0.7	-13.1	-5.1
Intermediate goods	19.3	7.8	1.9	-4.1	-4.3
Consumption goods	20.5	19.0	6.2	-1.6	-12.2
Trade balance (RM bil)	13.5	15.1	17.7	19.0	15.2

Source: Department of Statistics, Malaysia

Strong recovery in tourist arrivals

Reflecting increased confidence in air travel in the aftermath of the SARS outbreak, tourist arrivals picked up to 2.5 million arrivals in the third quarter from 1.7 million in the second quarter. Tourist arrivals from the ASEAN region have reached levels attained in the pre-SARS period. Promotional campaigns were conducted during the quarter in SARS-affected countries such as People's Republic of China, Hong Kong China and Chinese Taipei and in new markets such as Pakistan. These were supplemented by the restoration of flights to and from SARS-affected countries and the launch of chartered flights to the People's Republic of China. As a consequence, tourist arrivals from the People's Republic of China, Hong Kong China and Chinese Taipei doubled on a preceding quarter basis. Going forward into the fourth quarter, tourist arrivals are expected to exceed the one million monthly arrivals level attained in the pre-SARS period.

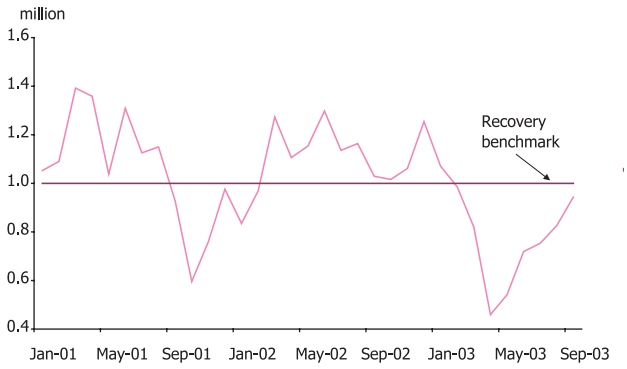
Sustained inflows of investment funds

On a cash basis, gross inflows of funds for investments (FDI) remained high, although moderately lower than the previous quarter (RM4 billion; 2Q 2003: RM5.7 billion). During the quarter, new inflows of equity doubled. Lower inflows reflected mainly lower draw-down of inter-company loans as more funding was sourced from domestic financial institutions. In the third quarter, higher FDI inflows were mainly channelled into the services sector, in particular financing and business services, wholesale and retail trade, and the transport industry. There were also new investments in the manufacturing sector, particularly in the semiconductor and petroleum-related activities. After adjusting for outflows due mainly to loan repayment by related companies, FDI recorded a net inflow of RM1 billion.

Overseas investment recorded a net outflow of RM1.6 billion (2Q 2003: -RM2.6 billion). In terms of gross outflows, more than a third of these investments were effected by the investment holding companies for investment in the transportation, manufacturing and services sectors in Singapore, Mauritius and South Korea. There were also significant investments by companies in the oil and gas in Africa, and manufacturing sectors, particularly the electrical and electronics industries in the US and Switzerland. An important development is the increasing repatriation of profit and dividend by Malaysian corporates operating abroad. In the period January to September 2003, RM1.3 billion was repatriated, compared to RM1.4 billion for the whole of 2002.

Portfolio investment recorded a higher net inflow, amounting to RM3.6 billion (2Q 2003: RM 0.6 billion), as improved domestic and foreign investor sentiments led to more robust activities on the KLSE.

Monthly Tourist Arrivals



Source: Tourism Malaysia

External debt remains manageable

The significantly large repayments and prepayments (RM6.6 billion) during the quarter offset somewhat the exchange revaluation loss, resulting in Malaysia's external debt stabilizing at RM194 billion (US$51 billion) as at end September 2003, equivalent to 54% of GNP. The repayments and prepayments of **medium and long-term external debt** were mainly by the non-financial public enterprises (NFPEs) and, to a lesser extent, the Federal Government. This is the sixth consecutive quarter of net repayments by the NFPEs, reflecting the settlement of several large external loans. In the private sector, repayments were effected by companies operating in the telecommunication, manufacturing and agriculture sectors. After taking into account the exchange revaluation loss following the appreciation of yen and euro, the medium and long-term debt was slightly higher at RM158.1 billion or US$41.6 billion (2Q 2003: RM157.9 billion).

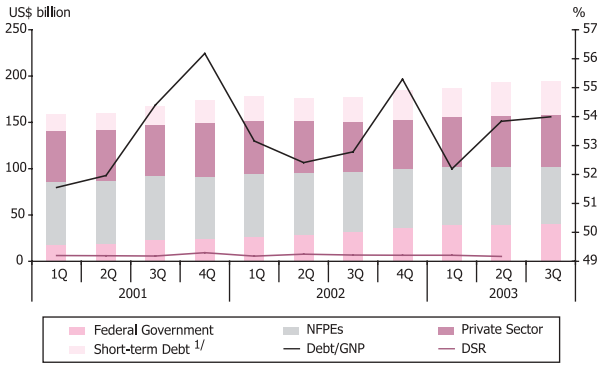
Short-term external debt remained stable at RM35.9 billion or US$9.5 billion (2Q 2003: RM35.6 billion). As at end-September, the short-term debt accounted for only 18.5% of total external debt, and is about 23.2% of the net international reserves.

External Debt Outstanding

	2002	2003	
	3Q	2Q	3Q
	RM billion		
Medium & Long-term debt	151.3	157.9	158.1
Public sector	97.1	102.1	102.2
Private sector	54.3	55.8	55.8
Short-term debt [1]	25.8	35.6	35.9
Total external debt	177.1	193.4	194.0
- US$ billion equivalent	46.6	50.9	51.0

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

External Debt



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

Under the IMF Special Data Dissemination Standard (SDDS) on external debt, currency and deposits held by non-residents with banking institutions were included in the coverage of external debt with effect from 30 September 2003. While Bank Negara Malaysia has adopted this coverage for external debt in the SDDS templates, publications by Bank Negara Malaysia, for the time being, will not include currency and deposits held by non-residents with banking institutions in the external debt tables. This item will continue to be shown as part of external liabilities of the banking system in the monthly statistics published by Bank Negara Malaysia. To be consistent with the SDDS coverage, Bank Negara Malaysia intends to adjust the external debt tables in all its publications at a future date, when the new Bank Negara Malaysia statistical system to collate external debt data is completed.

International reserves increased further

The rising trend in the international reserves of Bank Negara Malaysia continued into the third quarter. As at 30 September 2003, the net international reserves amounted to RM154.8 billion or US$40.7 billion, reflecting an increase of RM13.9

billion or US$3.7 billion since end-June 2003. The increase in reserves was attributed mainly to sustained repatriation of export earnings and inflows of foreign funds for direct and portfolio investment. The reserves level at the end of September has also taken into account the quarterly adjustment of the unrealised foreign exchange revaluation gain amounting to US$542 million, mainly as a result of the appreciation of euro and yen against the US dollar during the quarter.

The international reserves increased further to RM165.8 billion or US$43.6 billion as at 31 October 2003, attributed largely to sustained repatriation of export earnings and larger inflows of foreign direct investment and portfolio funds . The current level of reserves is adequate to finance 6.9 months of retained imports and is 4.7 times the short-term external debt.

Smaller fiscal deficit

While the budgetary operations of the Federal Government remained supportive of domestic economic activities in the third quarter, the Federal Government recorded a lower deficit of RM4 billion or 4% of GDP (2Q 2003: -8.4% of GDP). The improvement came from both lower expenditure and higher revenue. Stronger revenue performance in the third quarter arose largely from higher investment income and petroleum-based revenue. Most sources of indirect taxes registered better growth following the pick-up in aggregate demand. Lower receipts for service tax was due to the exemption of service tax for hotels and restaurants under the economic package announced in May 2003.

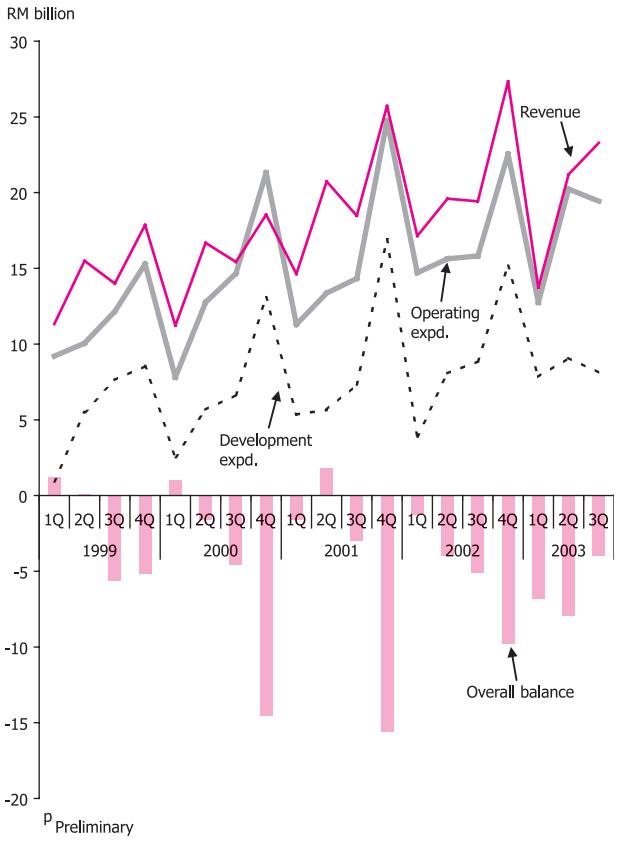
The deficit was financed through non-inflationary domestic borrowings, given the ample

Federal Government Finance [p]

	2002		2003		
	3Q	Jan.-Sept.	2Q	3Q	Jan.-Sept.
	RM billion				
Revenue	19.4	56.2	21.2	23.3	58.2
% growth	5.1	4.3	8.1	19.9	3.6
Operating expenditure	15.8	46.2	20.2	19.4	52.4
% growth	10.4	18.4	29.4	22.9	13.5
Current account	3.6	10.0	1.0	3.9	5.8
% of GDP	3.9	11.8	1.0	3.9	2.0
Gross development expenditure	8.9	20.8	9.1	8.1	25.0
% growth	20.8	13.5	12.7	-8.5	20.2
Loan recoveries	0.1	0.4	0.1	0.3	0.5
Overall balance	-5.1	-10.4	-8.0	-4.0	-18.8
% of GDP	-5.5	-12.3	-8.4	-4.0	-6.5
Memo item:					
Total gross expenditure	24.7	67.0	29.3	27.5	77.4
% growth	13.9	16.8	23.7	11.6	15.6
Total Federal Government debt (as at end period)	156.7	156.7	182.1	188.6	188.6
% of GDP	43.4	43.4	47.2	48.9	48.9
Domestic	124.6	124.6	142.3	148.4	148.4
External	32.1	32.1	39.9	40.2	40.2

[p] Preliminary

Federal Government Finance [p]



[p] Preliminary

liquidity situation. Total Federal Government debt rose moderately by 3.6% to RM188.6 billion, accounting for 48.9% of GDP as at end-September 2003 (47.2% as at end-June). The Federal Government's external debt was contained at 20.7% of the nation's external debt.

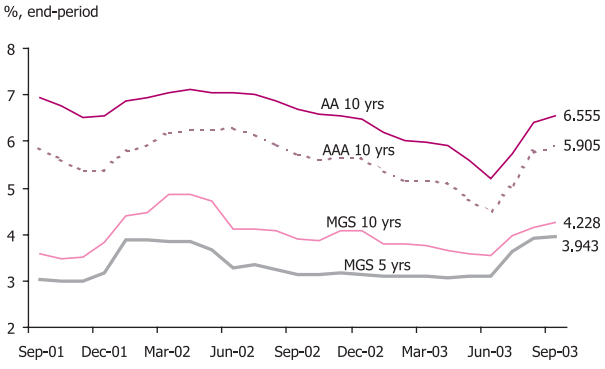
Accommodative monetary policy contributed to robust domestic demand

Monetary and financial indicators for the third quarter also supported the increasing robustness in domestic demand. While the policy rate of Bank Negara Malaysia, the 3-month Intervention Rate remained unchanged at 4.5% during the quarter, the effect of the earlier 50 basis point reduction in May 2003 and increased competitive environment were reflected in the further reduction in average lending rates of commercial banks and finance companies. As consumer and business sentiment strengthened with the improving outlook for the economy, low interest rates were effective in supporting growth, especially in stimulating private investment.

Interest Rates

	2002	2003	
	3Q	2Q	3Q
	At end-period (%)		
3-month Intervention rate	5.0	4.5	4.5
Interbank rates			
Overnight	2.74	2.77	2.75
1- month	2.98	2.98	2.99
Base lending rates (BLR)			
Commercial banks	6.39	6.00	6.00
Finance companies	7.45	6.90	6.90
Average lending rates			
Commercial banks	6.62	6.22	6.17
Finance companies	9.92	9.28	9.16
Fixed deposit rates			
Commercial banks			
3-month	3.20	3.00	3.00
12-month	4.00	3.70	3.70
Finance companies			
3-month	3.20	3.01	3.00
12-month	4.00	3.72	3.68

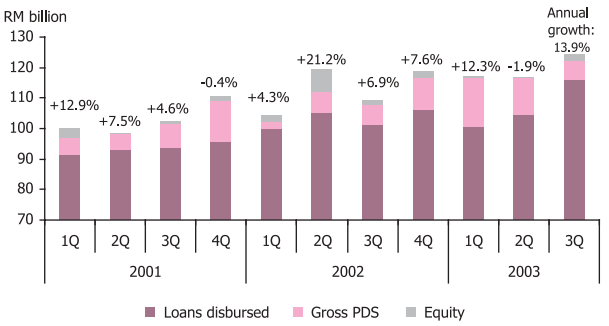
Long-term Interest Rates



Higher financing activity

The improving business confidence and rising domestic demand was reflected in higher financing requirements during the quarter. Total gross private sector financing raised through the banking system and from the capital market increased significantly, at an annual rate of 13.9% in the third quarter to RM124.5 billion (2Q: RM117 billion). A significant portion of the increase in demand for financing was met with funds sourced mainly from the banking system. Notably, there was higher growth in overall loan disbursements as well as the forward-looking indicators of total approvals and applications. During the quarter, loans disbursed by the banking system rose at a stronger annual rate of 14.6%.

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 b)			Annual growth	
	2002	2003		2003	
	3Q	2Q	3Q	2Q	3Q
Gross total financing	**109.3**	**117.0**	**124.5**	**-1.9**	**13.9**
Loans disbursed	101.1	104.5	115.9	-0.3	14.6
Gross PDS[2]	6.2	12.0	6.4	62.1	2.6
Equity	1.9	0.6	2.2	-91.8	14.4
				(At end period, %)	
Net total financing (A)+(B)	**9.6**	**14.1**	**13.0**	**7.7**	**8.2**
Banking system	6.8	8.3	10.1	5.1	5.7
Loans outstanding[1] (A)	4.3	10.4	8.7	3.8	4.7
Holding of PDS	2.5	-2.1	1.4	31.6	24.3
PDS outstanding[2] (B)	5.3	3.7	4.3	27.2	24.9

1 Banking system loans include loans sold to Cagamas and loans sold to Danaharta.

2 Private debt securities (PDS) exclude Cagamas bonds since financing raised by Cagamas is already reflected in banking system loans.

Loans disbursed were markedly higher to the small and medium enterprises (SMEs), the household sector as well as large corporations. Overall, loans disbursed to businesses increased at a stronger annual rate of 17% compared with 14.1% in the household sector. By sector, the increase in loans disbursed to businesses was broad-based, with a higher share recorded to the finance, insurance and business services, and transportation, storage and communication sectors. The pick-up in bank lending to businesses reflected the increasing robustness in the economy as well as some postponements in fund raising exercises in the bond market following the steepening of the yield curve on expectations of an improved economic outlook.

Loans by Sector

	Loans disbursed				Loans Outstanding
	During the Quarter			Share of total	Share of total
	2002	2003			
	3Q	2Q	3Q	3Q	
	RM billion			%	
Business enterprises	67.9	71.5	79.5	68.6	49.3
Large Corporations		*52.3*	*57.5*	*49.6*	*33.7*
SMEs		*19.1*	*21.9*	*19.0*	*15.6*
Households	26.8	27.3	30.6	26.4	44.2
By sector					
Agriculture, hunting, forestry and fishing	2.3	2.5	3.1	2.6	2.2
Mining and quarrying	0.5	0.3	0.7	0.6	0.3
Manufacturing	26.0	26.7	27.9	24.1	13.1
Broad Property Sector	18.8	19.0	21.1	18.2	38.5
Construction	*6.6*	*6.6*	*7.3*	*6.3*	*7.1*
Purchase of residential property	*8.0*	*8.6*	*9.7*	*8.4*	*22.1*
Purchase of non-residential property	*2.2*	*2.3*	*2.6*	*2.3*	*5.9*
Real Estates	*2.1*	*1.5*	*1.4*	*1.2*	*3.4*
Electricity, gas and water supply	1.6	1.6	2.0	1.7	1.2
Wholesale, retail, restaurants and hotels	16.0	17.5	17.1	14.8	7.9
Transport, storage and communication	2.5	3.5	4.3	3.7	2.9
Finance, insurance and business services	5.1	6.2	9.7	8.4	6.5
Consumption Credit	17.6	17.3	18.9	16.3	17.2
Of which:					
Credit Cards	*6.5*	*7.1*	*7.9*	*6.8*	*2.3*
Purchase of Passenger Cars	*6.8*	*6.0*	*6.7*	*5.8*	*11.7*
Purchase of securities	2.4	2.7	4.0	3.4	6.0
Purchase of transport vehicles	0.5	0.2	0.2	0.2	0.6
Others	7.7	6.9	6.9	6.0	3.5
Total	**101.1**	**104.5**	**115.9**	**100.0**	**100.0**

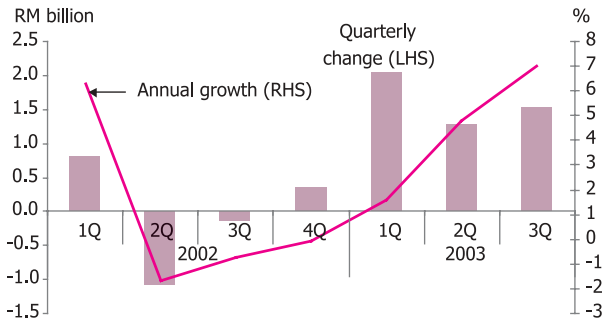
Loan Indicators

	During the quarter			Annual growth		
	2002	2003		2002	2003	
	3Q	2Q	3Q	3Q	2Q	3Q
	RM billion			(%)		
Total						
Loan applications	58.2	53.0	62.8	18.1	-8.2	7.8
Loan approvals	37.4	38.4	40.1	6.1	6.8	7.1
Loan disbursements	101.1	104.5	115.9	8.0	-0.3	14.6
Loan repayments	101.1	96.8	109.9	10.1	-3.3	8.7
Change in outstanding[1]	4.3	10.4	8.7	7.0	3.8	4.7
of which:						
Business enterprises						
Loan applications	35.5	28.3	33.7	n.a.	-16.7	-5.0
SMEs	n.a.	9.7	12.1	n.a.	n.a.	n.a.
Others	n.a.	18.5	21.6	n.a.	n.a.	n.a.
Loan approvals	19.0	19.9	20.3	11.1	11.5	7.0
SMEs	n.a.	5.9	6.4	n.a.	n.a.	n.a.
Others	n.a.	14.0	13.9	n.a.	n.a.	n.a.
Loan disbursements	67.9	71.5	79.5	3.3	-2.8	17.0
SMEs	n.a.	19.1	21.9	n.a.	n.a.	n.a.
Others	n.a.	52.3	57.5	n.a.	n.a.	n.a.
Loan repayments	69.8	66.3	77.0	0.0	-4.0	10.4
Change in outstanding[1]	-1.8	3.8	0.4	-3.3	-1.7	-0.9
SMEs	-0.1	1.3	1.5	-0.8	4.8	7.0
Others	-1.7	2.5	-1.1	-4.2	-4.4	-4.1
Households						
Loan applications	22.4	24.0	28.1	n.a.	9.5	25.2
Loan approvals	17.7	18.2	19.2	2.5	1.7	8.2
Loan disbursements	26.8	27.3	30.6	12.9	6.2	14.1
Loan repayments	20.9	21.6	23.8	14.4	6.5	13.5
Change in outstanding[1]	7.8	5.9	7.9	17.1	12.7	12.2

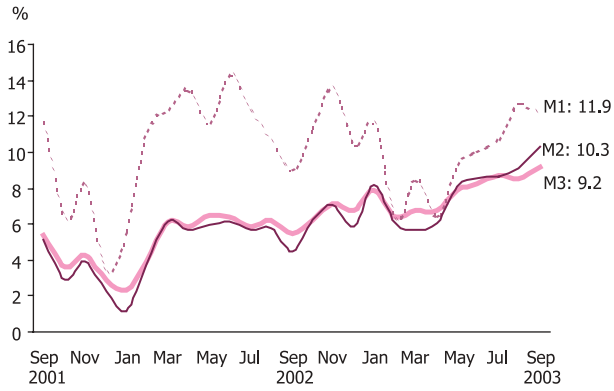
1/ The annual growth is for end-period

On a net basis, total outstanding loans increased at an annual rate of 4.7% at end-September, faster than the growth recorded at end-June of 3.8%. Outstanding loans to the SMEs, which accounted for 15.6% of total outstanding loans and 31.5% of total loans outstanding to businesses, rose

Sustained expansion in bank lending to SMEs



Monetary Aggregates: Annual Growth



at a stronger rate of 7% (4.8% as at end-June). In the first nine months, outstanding loans to the SMEs expanded by RM4.8 billion. During the same period, a total of RM18.9 billion was approved to 57,877 SMEs, while RM62.2 billion was disbursed.

Overall, net financing provided by the banking system through extension of loans and its holdings of PDS expanded by 5.7% as at end-September, while net total financing through the banking system and private debt securities market expanded by 8.2%. The loans to deposits ratio, including holdings of private debt securities, remained high at 93.5% at end-September (93.7% at end-June).

Growth in monetary aggregates increased

Growth in all three monetary aggregates increased, reflective of the significantly improved consumer and business sentiments. While stronger expansion in M1 (11.9%) reflected increased demand for liquidity from consumers and businesses, higher growth in M3 (9.2%) was supported by the increase in lending by the banking system and expansionary external operations.

M3 Determinants

	Change during the quarter		
	2002	2003	
	3Q	2Q	3Q
	RM billion		
M3	7.5	8.7	13.0
Net claims on Government	4.9	5.3	-5.5
Claims on private sector	6.4	8.6	13.0
Net external operations[1]	-2.1	0.3	10.6
Other influences	-1.7	-5.5	-5.1

[1] Pre-revaluation

Capital Markets

Higher funds raised in the market

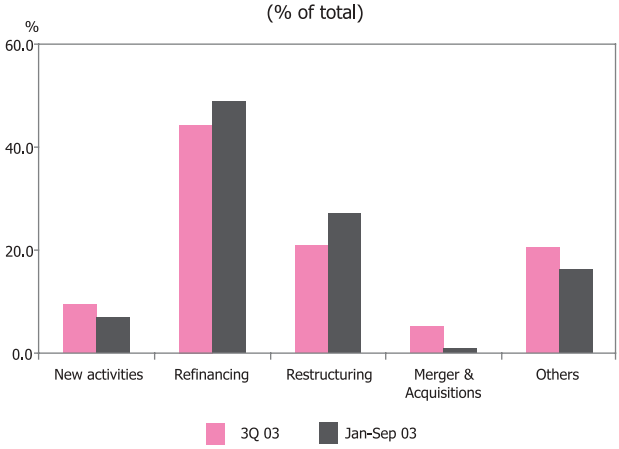
In the third quarter, funds raised through the capital market rose further reflecting the higher funds raised in the equity market. Total net funds raised through new issuances of private debt securities (PDS), new listings on the equity market and several re-openings and new issuances of Malaysian Government Securities (MGS) amounted to RM13.5 billion (RM10.8 billion in the previous quarter).

Improved performance of the Kuala Lumpur Stock Exchange (KLSE) in the third quarter

encouraged the private sector to source financing from the equity market. Funds raised in the equity market were significantly higher during the quarter totalling RM2.2 billion. There were 19 new listings on the KLSE, with seven listings on the Main and Second Board each and five listings on MESDAQ. The amount raised through the IPOs totalled RM505 million and was issued by companies in the technology, industrial and consumer product sectors. During the quarter, seven companies were delisted.

On a gross basis, new issues of PDS (excluding Cagamas bonds) declined to RM6.4 billion (RM12 billion in the previous quarter). The steepening yield curve on expectations of an improved economic outlook prompted some corporations to delay issuance and seek bridging financing from the banking system. The new issues were mainly in the form of asset-backed securities and straight bonds. After adjusting for redemption, the net funds raised through the PDS market were lower amounting to RM3.7 billion (RM4.5 billion in the previous quarter). Funds raised through the PDS market during the quarter were mainly for refinancing (44.3% of total issuance) and restructuring purposes (20.7%).

Private Debt Securities Issued by Purpose



Funds Raised in the Capital Market

	2002		2003[p]		
	3Q	Jan-Sep	2Q	3Q	Jan-Sep
	RM million				
By Public Sector					
Government Securities, *gross*	3,677	10,266	8,132	12,632	38,494
Less Redemptions	1,000	6,900	1,500	6,800	18,600
Less Government holdings	-	-	-	-	-
Equals Net Federal receipts	2,677	3,366	6,632	5,832	19,894
Khazanah Bonds, *net*	-	-	(138)	(183)	556
Govt. Investment Issues, *net*	-	-	-	-	1,729
Malaysia Savings Bond, *net*	(3)	466	(2)	(2)	(7)
Net Funds Raised	2,674	3,832	6,492	5,647	22,172
By Private Sector					
Shares	1,935	11,179	592	2,157	3,349
Debt securities	8,456	24,495	12,911	10,165	40,483
Private Debt Securities (PDS)	*6,211*	*16,025*	*11,966*	*6,370*	*34,522*
Cagamas	*2,245*	*8,470*	*945*	*3,795*	*5,960*
Less Redemptions	3,458	23,866	9,240	4,482	15,898
Net Issues	4,997	628	3,671	5,684	24,584
Net issues (excluding Cagamas)	*5,077*	*(2,795)*	*4,497*	*3,744*	*23,776*
Net Funds Raised	6,932	11,808	4,263	7,840	27,934
Total Net Funds Raised	9,606	15,640	10,755	13,487	50,107

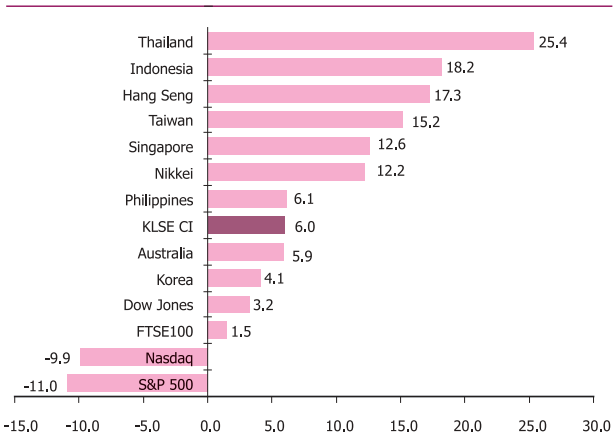
[p] Preliminary.

Further strengthening of the equity market

The performance of the KLSE improved further in the third quarter. Market sentiment was lifted by improved outlook for growth in the Malaysian economy performance, favourable corporate developments and the generally strong performances of global and regional bourses. For the third quarter, the KLSE CI was higher by 6%, and registered a rise of 13.5% since end-2002. Market capitalisation and average daily trading activities were higher at RM572.3 billion and 644.3 million units respectively. Renewed foreign interest was strongly present in the KLSE, while the active retail participation reflected, to some extent, the conversion of board lots to 100 shares on 26 May 2003.

Market sentiment has continued to improve as result of a number of positive developments, including the upgrade of Malaysia's long-term foreign currency sovereign credit rating by Standard & Poor's. As at 14 November, the KLSE CI closed at 792.2 points (+8.1% since end-September) with market capitalisation higher at RM636.7 billion (+11.3% since end-September).

Performance of Selected Global and Regional Markets in the Third Quarter of 2003



KLSE: Selected Market Indicators

	As at end				
	2002		2003		
	3Q	Jan-Sep	2Q	3Q	Jan-Sep
Price Indices					
- Composite	638.01	638.01	691.96	733.45	733.45
- EMAS	155.39	155.39	170.23	182.03	182.03
- Second Board	102.89	102.89	108.96	122.03	122.03
Average daily turnover					
- Volume (million units)	159.1	251.3	286.7	644.3	389.4
- Value (RM million)	349.2	536.8	457.2	958.1	605.0
Market Capitalisation (RM b)	476.35	476.35	532.45	572.26	572.26
No. of Companies Listed	859	859	877	889	889

Source: Kuala Lumpur Stock Exchange

KLSE: Turnover of Corporate Securities

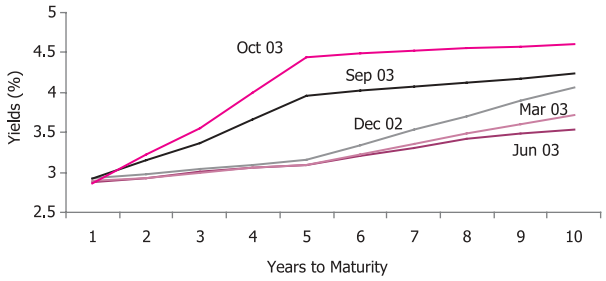
	2002				2003					
	3Q		Jan-Sep		2Q		3Q		Jan-Sep	
	million units	RM million	million units	RM million	million units	RM million	million units	RM million	million units	RM million
Turnover	10,501	23,045	46,740	99,854	17,775	28,349	41,877	62,274	72,039	111,916
of which:										
Main Board	8,857	20,888	39,748	87,653	14,421	24,648	27,849	46,225	52,879	90,270
of which:										
- Consumer Products	327	1,504	1,379	6,593	509	1,959	857	2,768	1,675	6,208
- Industrial Products	738	1,447	3,098	5,133	1,429	2,105	3,911	5,406	6,050	9,046
- Construction	745	1,516	3,388	7,465	1,181	1,796	2,088	3,967	4,751	7,450
- Trading/Services	2,382	8,171	9,839	31,555	3,329	9,009	5,993	14,829	12,113	31,002
- Finance	1,370	4,386	6,039	18,753	1,908	4,422	3,497	8,471	6,937	16,676
- Properties	963	765	4,658	4,279	2,942	2,210	5,215	4,567	9,527	7,743
- Plantations	234	1,016	990	4,024	307	1,129	675	1,815	1,278	4,228
- Mining	45	106	205	509	53	92	42	67	143	251
Second Board	1,462	2,079	6,670	12,010	2,685	3,377	8,069	12,103	12,345	17,286

Source: Kuala Lumpur Stock Exchange

Lower secondary trading in the bond market

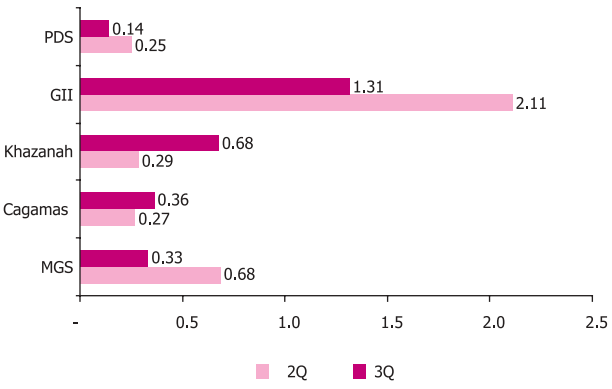
Total turnover in the secondary bond market contracted to RM97.4 billion in the third quarter amidst a steepening yield curve (RM153.1 billion in the previous quarter). During the quarter, the yields for MGS increased by 85 basis points for 5-year MGS and 70 basis points for 10-year MGS. The higher yields on all papers and tenures were affected by higher yields in the US Treasury market and improved optimism on the global, regional and domestic economic outlook.

Steepening of MGS Yield Curves



Amidst subdued trading, MGS remained as the most actively traded paper, accounting for 43.1% of total trade. Cagamas bonds and Khazanah bonds recorded higher trading activity during the quarter,

Liquidity Ratio: Turnover/Outstanding

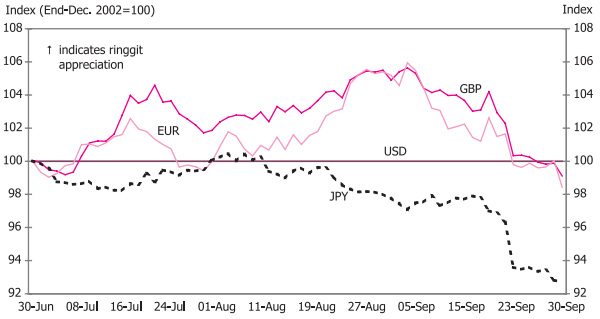


due partly to the higher issuance of Cagamas bonds as well as a new issue of Khazanah bond to replace a maturing issue.

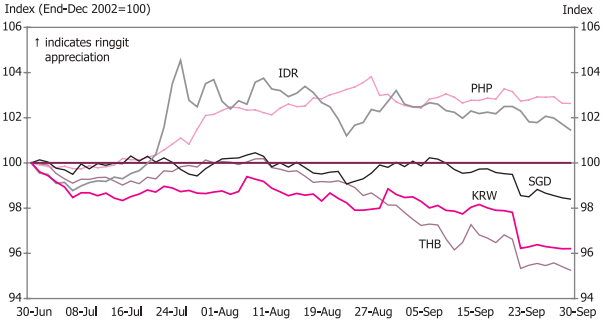
Exchange Rates

In line with the movements of the US dollar in the international foreign exchange markets in the third quarter of 2003, the ringgit depreciated against the major currencies while recording a mixed performance against regional currencies. The dollar firmed earlier in the quarter on market optimism over improved prospects for US economic recovery. However, the dollar weakened towards the end of the period as markets shifted their focus onto the large current account and fiscal

Ringgit Performance Against Major Currencies



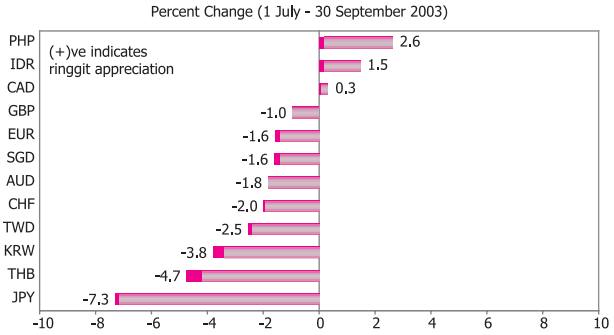
Ringgit Performance Against Regional Currencies



deficits. The weakness of the dollar also reflected strong market reaction to the statement of the G-7 Finance Ministers and Central Bank Governors on 20 September, highlighting the desirability of exchange rate flexibility to facilitate current account adjustments and a more balanced global growth. The Japanese yen appreciated due to the strong stock market performance and expectations that exchange rate interventions would be less aggressive. Regional currencies largely benefited from market expectations of a global economic recovery, portfolio inflows and a firmer Japanese yen.

The ringgit exchange rate continues to be well supported by the strong level of foreign exchange reserves, low inflation, continued surpluses in the current account, low external debt as well as a strong and resilient banking system.

Summary of Ringgit Performance Against Selected Currencies



Performance of Ringgit against Selected Currencies

RM per foreign currency	End-June 1997	2 September 1998	End 2Q 2003	End 3Q 2003	% change since [1] End-June 1997	% change since [1] 2 September 1998	% change since [1] End 2Q 2003
US dollar	2.5235	3.8000	3.8000	3.8000	-33.6	0.0	0.0
Euro	-	-	4.3463	4.4160	-	-	-1.6
Pound Sterling	4.1989	6.3708	6.2835	6.3439	-33.8	0.4	-1.0
100 Japanese yen	2.2088	2.7742	3.1708	3.4205	-35.4	-18.9	-7.3
Singapore dollar	1.7647	2.1998	2.1631	2.1984	-19.7	0.1	-1.6
100 Thai baht	9.7470	9.3713	9.0541	9.5048	2.5	-1.4	-4.7
100 Philippine peso	9.5878	8.8302	7.0995	6.9179	38.6	27.6	2.6
100 Indonesian rupiah	0.1038	0.0354	0.0459	0.0452	129.6	-21.7	1.5
100 Korean won	0.2842	0.2827	0.3178	0.3304	-14.0	-14.4	-3.8

[1] (+) indicates appreciation of ringgit against respective currency and (-) indicates depreciation.

DEVELOPMENTS IN THE BANKING SYSTEM

The banking system continued to exhibit a sound financial position. Favourable developments were observed with non-performing loans (NPLs) continuing to decline whilst capital was sustained at a high level, providing an adequate buffer to withstand any financial shocks to the system. Higher income was recorded as a result of stronger loan growth and, coupled with lower operating expenses, led to higher gross operating income.

Strong capital position supporting larger banking operations

The capital base remained unchanged at a high level of RM69 billion as at end-September 2003. Meanwhile, the risk-weighted assets expanded by 2.1% during the quarter due mainly to the higher volume of loans. Consequently, the risk-weighted capital ratio declined by 0.3 percentage points to 13.4% at end-September 2003, whilst the core capital ratio was 0.2 percentage points lower at 10.9%.

Strong capital position

	2002		2003		
	Sep.	Dec.	Mar.	Jun.	Sep.
Capital					
Core-capital ratio (%)	11.0	11.1	11.0	11.1	10.9
RWCR (%)	13.3	13.2	13.2	13.7	13.4

Higher operating surplus due to strong operating income and contained costs

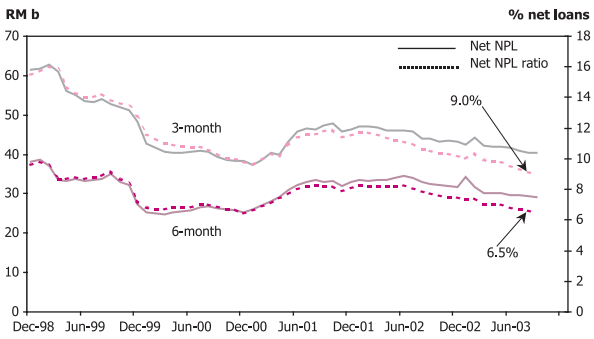
The banking system recorded a higher gross operating profit of RM3 billion in the third quarter (RM2.9 billion in the second quarter) due mainly to higher income from lending and financing activities, better returns on investment securities and stronger income from fee-based activities. Interest expense on deposits was lower in the third quarter while operating costs declined marginally by 0.8%.

Following the decline in NPLs, the amount of net loan loss provisioning charges declined substantially by RM1.1 billion during the quarter to RM2.2 billion. The higher operating surplus was, however, offset by a reduction in net income from trading and investment activities of RM0.7 billion, particularly for the commercial and merchant banks, largely attributed by the fall in bond yields during the quarter. Consequently, profit before tax during the third quarter amounted to RM2.4 billion (2Q 2003: RM2.7 billion).

Further improvements in NPLs

Net NPL ratios on 6- and 3-month classifications declined to 6.5% and 9% respectively at end-September 2003 (end-June: 6.8% and 9.5% respectively). The lower NPLs were due

Banking System: Non-performing loans



mainly to the significantly lower amount of newly classified NPLs of RM5.3 billion (RM7.3 billion in the second quarter). In addition, the banking institutions continued to record strong recoveries and reclassification of RM4.9 billion. Meanwhile, the loan loss coverage ratio remained stable at 61.4%.

By economic sector, the level of NPLs for the business sector continued to record improvements. Gross NPL ratio declined to 15.9% as at end-September 2003 compared with 16.3% at end-June 2003. The largest decline was observed in NPLs for community, personal and social services sector, and financial services sector following the implementation of a number of restructuring exercises. NPLs for the household sector remained at 8.2%.

Opening Remarks at the Launch of the Consumer Education Programme for the Insurance and Takaful Sector
Shangri-La Hotel, Kuala Lumpur
29 August 2003
by
Tan Sri Dato' Sri Dr. Zeti Akhtar Aziz
Governor,
Bank Negara Malaysia

The economic and financial landscape in Malaysia has undergone significant transformation. In the process, the economy has become more diversified with new sources of growth. In tandem with these changes, we have seen the modernization of the financial sector that has also become increasingly diversified to meet the new requirements of the economy. There have also emerged new distribution channels and channel convergence within the financial sector. The financial sector has increasingly leveraged on advances in technology, which has significantly changed the way financial business is being conducted. As market advances continue to expand the range of financial products and services, consumers are being faced with increasingly complex choices and options in the management of their personal finances and exposure to risk. In this more complex financial landscape, it becomes important for consumers to have improved access to information. Financial education for Malaysian consumers is central to this process. It is therefore a matter that is accorded high priority by the Central Bank.

It therefore gives me great pleasure today to launch the Consumer Education Programme for the insurance and takaful industries. This represents an important step in the ongoing evolution of the development of our financial system. Indeed, this also represents a part of the overall efforts to promote market integrity and consumer protection over the whole spectrum of banking, insurance and takaful activities in the market. For consumers to fully realise the benefits of increased opportunities available in this continuously changing financial environment, consumers need to be in a position to actively manage their financial assets while at the same time safeguard their financial future.

The public response to the launch of the Consumer Education Programme for the banking sector early this year has been most encouraging. To date, more than two million visitors have accessed the Bank Negara Malaysia's "Banking Info" website and more than 360,000 booklets have found their way into the hands of consumers. The launch of the Consumer Education Programme for the insurance and takaful industries today will be part of this on-going effort to enhance the ability of consumers to understand and draw meaningful comparisons of alternative financial products and make better-informed decisions in financial planning.

In formulating a consumer education strategy, the distinct features of the insurance industry have been taken into consideration to meet the information needs of insurance consumers. Insurance contracts are essentially formed on the basis of disclosures made by prospective policyholders about the risks to be insured. Such

disclosures determine if an insurer will assume the risk and the price at which it is assumed. The ability to enforce a claim against an insurer will depend on the accuracy and completeness of the disclosures. This underwriting and claims assessment process distinguishes insurance from other financial products. There is also a wider range of intermediaries in the insurance industry compared with other financial service industries. The entire spectrum includes the insurance agents, insurance brokers and advisers in the distribution process, and the loss adjusters, managed care organizations, lawyers and auto repair workshops in the claims process.

The unique features of insurance have significant implications on disclosures and liabilities, which directly affect the insuring public. The implications become even more significant as competitive pressures give rise to the rapid introduction of new products that require a better understanding of what they entail on the part of the average consumer. The specific objectives of the Consumer Education Programme for the insurance and takaful sector are therefore:

- to promote public understanding of critical information when buying insurance and takaful products and services;
- to familiarise the public with the underwriting and claims processes; and
- to create awareness of ethical market practices such that consumers can be more assertive and discerning in making decisions.

The Consumer Education Programme seeks to provide relevant information to consumers about insurance products: their costs and benefits, processes and documentation involved in the insurance cycle and, more importantly, the rights and responsibilities of the various parties to an insurance contract. It is also to promote greater awareness among consumers about the means and avenues for redress in the event of dispute or dissatisfaction with any insurance product or service.

This Consumer Education Programme for the insurance sector will extend over a 10-year horizon and will be undertaken on several levels under a step-by-step approach to reach out to the various target groups. Similar to the Consumer Education Programme for banking, the insurance education programme has been given the acronym: "InsuranceInfo" (or "InfoInsurans" in Bahasa Malaysia). Over time, it is envisaged that the acronym and the programme will become readily recognizable in the public domain.

In its first year, the Consumer Education Programme will focus on the wide dissemination of information in 12 priority areas that have been identified. These include issues on the fundamentals of insurance and takaful products and services, highlighting the important terms and conditions, rights and obligations under a policy contract as well as the redress avenues available, and the common insurance and takaful products. With participation from the insurance associations, Bank Negara Malaysia has produced 12 booklets that set out the important information for consumers in these areas. These booklets can be obtained from the principal offices and branches of insurance companies and takaful operators, as well as from selected branches of banks that have bancassurance arrangements with insurers.

In addressing the challenges of financial education, collaborative partnerships are important.

No single organisation can be expected to meet all the demands for consumer education. While Bank Negara will continue to actively engage the insurance industry in the development, production and dissemination of educational materials and initiatives, the process needs to be driven by the industry.

Insurance intermediaries provide the direct link to the insuring public and therefore is an essential part of the efforts to increase familiarity on insurance by the community. With approximately 147,000 agents currently in the market, the agency force can contribute significantly towards raising the level of financial literacy among Malaysians through InsuranceInfo. Similarly, the various consumer associations, through their direct contact with consumers, have an important role to play in promoting an active consumer movement by providing useful guidance to consumers in dealing with issues relating to insurance and takaful matters. Their wide network, close proximity, and good relationship with consumers can contribute towards the successful implementation of the Consumer Education Programme.

Just as the rapid deployment of new information technology has expanded the scope of financial services, so too, has it increased our options for meeting the challenges of financial education. In this regard, the InsuranceInfo website represents an important delivery channel which has significant potential to be used extensively to bring relevant and timely information to the public. All the pamphlets and booklets can be downloaded from the website. Over time, the website will be continually enhanced to provide for a more interactive and user-friendly interface with consumers that will also enable consumers to provide feedback on the programme and obtain prompt answers to their questions.

The Consumer Education Programme represents one of several important elements in the overall strategy of enhancing the consumer protection infrastructure. To achieve the desired outcome of high standards of market conduct that are founded on principles of integrity, sound ethics and professionalism, Bank Negara Malaysia has adopted a combination of regulatory policy instruments. These include policy development, regulatory initiatives, compliance reviews and ongoing surveillance. Recent initiatives that have been implmented in the area of strengthening market conduct within the insurance sector include:

- The framework for the introduction of qualified independent advisers is currently being finalized. Such independent advisors will form a new distribution channel for the sale of life insurance products. These intermediaries will be licensed under the Insurance Act and will be held to the highest standards of prudential conduct, accountability and governance to safeguard the interests of consumers.

- The entry requirements for agents have now been raised under a graduated implementation programme that commenced in April 2003. Under the programme, examinations have been made mandatory to maintain continuing education standards of agents.

- Guidelines dealing with unfair practices in insurance business have been introduced in April 2003 to provide a more comprehensive framework for the regulation of insurance

market practices. Among other things, the Guidelines provide for enhanced disclosures to consumers, requirements for insurance to be sold on equitable terms and conditions, and specific restrictions against misrepresentation and unfair discrimination.

- The Guidelines on Claims Settlement Practices introduced in 1995 have now been revised to incorporate new measures and improved market practices in claims handling, as well as the specification of minimum fraud control and risk management practices relevant to the claims process.

- A minimum standard on product disclosure and transparency in the sale of medical and health insurance policies was issued in May 2003. The standard requires insurers and their intermediaries to provide sufficient details of the essential features of medical and health policies so that policyholders will understand the important provisions of the policies, in particular, with respect to premiums, benefits, exclusions and limitations under the policies.

- A survey has also been commissioned to determine the level of consumer satisfaction with financial services, including insurance. The results of the survey will provide important input for the development of a service quality index for financial services that will serve as a benchmark for financial institutions to evaluate their service levels and identify areas for improvement.

In our efforts to promote a larger role for consumer activism, attention has also been directed at enhancing dispute resolution mechanisms for consumers to seek redress. Within the insurance sector, the Insurance Mediation Bureau established in 1992 constitutes the main avenue outside the court system for resolving disputes between policyholders and their insurers. To further enhance the role of the Insurance Mediation Bureau as a dispute resolution mechanism, an expanded scope for the Bureau involving higher limits for claims falling within its purview and the inclusion of third party claims is being considered. This will provide greater access to the Bureau for a wider spectrum of the insuring public. At the same time, efforts are also underway to merge the mediation bureaus of both the banking and insurance sectors into a single new Financial Mediation Bureau that will serve as a one-stop centre for the resolution of a broad range of retail consumer issues raised against the financial institutions that are regulated by the Central Bank.

With effect from 1 June this year, we have also made it a requirement for all insurers and takaful operators to establish dedicated complaints units in their respective organizations. The experience has been that most complaints can be resolved in-house by the service providers themselves, in particular those complaints that involve delays in claims settlements due to institutional procedures, which generally comprise the bulk of public complaints. The establishment of the complaints unit by insurers and takaful operators is expected to promote a more pro-active approach in the management of complaints. Such consumer complaints also provide valuable information regarding any shortcoming in the products and services. Responding to consumer complaints also promotes customer goodwill. Certainly, as consumer awareness and financial literacy increases with the implementation of this Consumer Education Programme, it is essential for financial service providers to recognise the opportunity to build

customer loyalty and increase customer retention through this mechanism.

The advent of new technology and other market innovations will bring new challenges and possibilities for businesses and consumers. We can expect that this pace of change in the financial services industry will continue to increase. In striving to adjust to these changes, we should not underestimate the significant improvements in financial and business practices that can be achieved by empowering consumers through education.

As we continue on this drive to raise the standards of individual economic and financial well-being through consumer education, the broad involvement of all parties involved in every stage of the programme's implementation is vital to encourage expanded linkages between business and consumer education on an ongoing basis. Our success in this important endeavour will have a significant bearing on how well prepared our society is to meet the challenges of an increasingly dynamic and complex financial environment.

Asia Pacific Bankers Club Conference
Shangri-la Hotel, Kuala Lumpur
15 September 2003
"Outlook and Prospects for Asia"

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

Powerful forces of change reinforced by global political, economic and financial developments have had pronounced implications on the economic and financial environment we operate in. It has not only dramatically changed our economic and financial landscape but has brought with it new uncertainties, risks and challenges. Despite these developments, the Asian region has demonstrated resilience and continues to emerge as the fastest growing region in the world. The issue before us is - to what extent can Asia continue to prosper in this increasingly more difficult and changed global environment? To what extent can Asia's previous successes be sustained in these more challenging circumstances?

It is my pleasure to be here today on this occasion of the Asian Pacific Bankers Club Conference on "Financial Stability and Challenges". Let me take this opportunity to also welcome the delegates to Kuala Lumpur. Indeed, high priority has been accorded by the economies in this region towards achieving financial stability. Varying degrees of financial restructuring and reform have been undertaken to strengthen domestic financial systems. Five years since the countries in this region emerged from the financial crisis we have seen financial stability restored and the financial systems significantly strengthened. Despite the more challenging environment in the more recent period, the financial systems in this region have demonstrated resilience. While this is a positive development, challenges remain. In view of the increasingly more difficult environment these efforts to strengthen the financial systems need to continue.

Today, I would like to focus my remarks on the background against which these efforts are being undertaken. In particular, I will focus on the emerging changes that are taking place in our region that are likely to be important in sustaining the growth prospects for this region. In the context of these changes, I will touch on the important role that the banking sector has in contributing to the growth and development process.

The region is highly integrated with the world economy in terms of the high volume of trade and investment flows between the region and the rest of the world. While this has contributed significantly to the strong growth in the region, it has also brought with it increased vulnerabilities arising from shifts in demand and reversals in investment flows. Indeed, developments in the advanced economies arising from the bursting of the technology bubble, the unprecedented declines in

the stock markets, uncertainties arising from international geopolitical tensions all had implications on this region.

In the current environment, clear signs are now beginning to emerge that the recovery in the advanced economies is strengthening and that this is already positive for the region. While the pace of growth in the major industrial countries is still below their potential, it has been revised upwards to reflect improved consumption and business investment activity. Most encouraging has been the indicators of business investment, particularly IT investment, which has been stronger-than-expected. This has been supported by improved corporate cashflows and the low interest rates environment. In Japan, signs of recovery have emerged while in the euro area, indicators of business sentiment suggest a stabilisation from the current weakness. **These developments augur well for growth in the region in the second half of this year and in 2004**. Indeed, the positive performance of the global stock markets reflected an anticipation of stronger future growth.

While these are encouraging trends for the region, we need to look beyond the prospects of the current cyclical recovery. Several significant **imbalances however, still remain in the global economy**. An important issue that needs to be addressed is how the unbalanced growth that has taken place in the world economy can be resolved with orderly adjustments of both the economies concerned as well as of the respective financial markets. The adjustments need to take place while maintaining robust overall global growth. Global growth still remains dependent on the US as an important trading partner. This is reflected in the large and persistent **current account and budget deficit** in the US as it continues to be the **net purchaser of world output**. Asia and the Euro area, on the other hand, continue to record large surpluses. This is also reflected in the significant **build-up of dollar assets in Asia** as US deficits are partially financed by capital inflows from Asian economies. Meanwhile, the adjustments to the previous excesses in investment still continue to restrain new investment, leaving growth to be dependant on the sustainability of consumption. These global imbalances are unsustainable in the medium-term. Moreover, any large and **disorderly adjustments in exchange rates** would have disruptive implications on growth in the region and for the overall global growth. Despite the severity of the Asian crisis, geopolitical uncertainties in the past few years, and most recently, the SARS outbreak, **Asia still remains the fastest growing region in the world**. Growth for the region as a whole for this year is forecast to be about one and a half times faster than the global average.

The issue before us is, to what extent can Asia ensure sustainability of the growth prospects over the long-term in this more difficult global economic environment? To what extent will the global imbalances place the burden of adjustment on the region? How can the region contribute towards a more balanced global growth? In dealing with these risks and pressures, the region is supported by several strong underlying factors that provide the foundations for securing our future growth.

Factors underlying Asia's Growth Prospects

First, domestic demand led growth

Domestic demand in the regional economies is becoming an increasingly important driver of growth that has considerable potential to contribute further in sustaining growth prospects for the Asian

region. The stronger domestic demand has also been reflected in the rising intra-regional demand for goods and services, thus providing a positive self-reinforcing effect for the region. While externally driven growth will continue to be important, the **increased focus on strengthening domestic demand will reduce vulnerability to external developments.**

Second, the role of private consumption

Given the focus on domestic demand to harness a more self-sustained and balanced economic growth, an important catalyst is the **role played by private consumption**. Private consumption is well positioned to further build the capacity of domestic demand in the region. The contribution of consumption to economic growth in regional economies has increased over time, supported by the expansion in per capita income in the region, which has increased by 4% per annum during the period 2000-2002. Consumption has also been supported by the fiscal and monetary stimulus that has been implemented in the region. This has enhanced incomes and strong credit expansion for household spending including for the purchase of housing. The tradition of high savings ranging to between 20% to 45% of GNP allows scope for encouraging a higher rate of consumption without undermining its sustainability. Household debt levels are also generally low. In addition, the household sector generally has a good track record in servicing their debt. Previous prudent fiscal policies has allowed an expansionary stance to support the growth while low inflation and excess capacity has allowed for the monetary stimulus.

Third, favourable demographic factors

The Asian region accounts for more than half of the world's population and continues to grow at a relatively high and stable rate. Of importance is that the region has a relatively young demographic structure with rising education, which augurs well for securing a large and dynamic labour force going into the future. These **favourable demographic prospects** of the region increase the potential for creating a consumer group with high purchasing power, thus providing an increased potential for growth in domestic demand.

Four, rising middle-income consumers

Rising income and urban migration in Asia has produced a **large and vibrant middle-income group**, creating a pivotal change in the pattern of consumption to deliver the positive benefits in domestic growth demand. Cumulative effects policies that have been implemented previously have resulted in increasing income and living standards and established the foundations to accentuate the transformation of domestic demand in the region. China's domestic market with a population of more than 1.2 billion, is already the world's largest market for mobile phones and is poised to be the world's largest market for personal computers. By 2005, it is estimated that 15% of China's population would consist of about 200 million middle-income consumers equipped with a high propensity to consume. By 2010, middle-income consumers in China are expected to increase to 400 million to 500 million thus making the China market comparable to that of the US.

Five, rising intra-regional trade

Rising economic integration has enabled the region to be more resilient in an increasingly volatile and uncertain external environment. The East Asian region has already developed a significant degree of economic integration as manifested in its **fairly high level of intra-regional trade**. The rise in intra-regional exports, which accounts for 34% of the East Asian region's exports in 2002, stemmed in part

from the higher contribution of domestic demand, which leveraged on the robust economic growth achieved by regional countries. Estimates indicate that about 30-70% of intra-regional trade is for final demand in the region. Of significance is the positive economic performance of China and India, which has generated increased sources of final consumer demand. Since 1993, China's role in the region has reversed from a net exporter to a net importer of the region. Intra regional trade within ASEAN has also increased significantly to account for 24% of the region's trade, exceeding the trade by the region with the United States.

Six, supportive policies for endogenous sources of growth

The region's commitment to harness domestic driven growth has been reinforced with **pro-active economic policies to provide an enabling environment to enhance the development of domestic businesses, in particular, small and medium scale enterprises**. Policy makers in the region recognise the challenges that emanate from a more competitive environment and have continued to re-examine and redefine strategies geared towards building the capacity of domestic enterprises and thereby enhancing their contribution to growth of the domestic economy. In addition, efforts have also been made to develop new areas of growth to ensure a more diversified economy. Countries have increasingly shifted to areas of their natural comparative advantages, whether in agriculture, ICT, construction and infrastructure or services-related sectors in order to benefit from their inherent strengths.

Seven, a new wave of FDI in the region

Apart from intra-regional trade, **intra-regional foreign direct investment (FDI) flows** have increasingly operated as a strong force for growth in the East Asian region. Regional FDI has largely been trade-related. Early FDI in East Asia was mainly derived from Western multinationals, particularly the US. The second wave of FDI after the late 1970s was predominantly Japanese capital which flowed into East Asia, in search of lower costs of production. Today, the cumulative stock of Japanese FDI has surpassed that of American investments. Since the late 1980s, as Taiwan, Hong Kong and Singapore transformed into capital surplus economies that moved up the value chain, investments by these newly industrialised economies gained significance in Asia. This has represented the "third wave" of FDI in the region. The East Asian region is thus receiving a steady inflow of FDIs from the NIEs to ASEAN and China. In the more recent period, this trend has been reinforced with increased overseas investments by Korea and Malaysia.

Eight, engaging the emergence of large new markets in the region

Overall, as a high level of integration exists at the regional level in terms of trade and FDI, shifts in trading and investment patterns both from outside to inside the region and within the region itself have been a dynamic process. Hence, given the **emergence of large new markets in the region**, the opportunities present in these markets show complementarities in the region. Countries in the region need to therefore focus on these complementarities in new potential areas of growth. In an increasingly competitive environment, economic progress in the region is benefiting from the strategic specialisations, which is supported by the leverage on comparative advantages.

Nine, regional cooperation gathers momentum

Given the existing mutual interest amongst countries in the region, regional cooperation efforts

are gathering momentum in East Asia, notably in the context of ASEAN+3 and EMEAP. To-date, the focus of such cooperation by Governments has been on regional surveillance, instituting institutional arrangements and according high priority to co-operation in trade and investment. The drive toward regional cooperation will continue to increasingly focus on enhancing regional trade and investment linkages to maximise the comparative advantage of each member country. Toward this end, studies have already been commissioned to explore the feasibility and identify the preconditions for the creation of an Asian common market, a logical long-term objective of regional cooperation.

Ten, strong underlying economic and financial fundamentals

The underlying fundamentals in the region are expected to continue to remain positive. Sustainable current account surpluses and strong international reserves positions all continue to support the growth prospects. The high savings rate, of between 20-45%, which allows for financing of pro-growth policy measures from domestic sources will continue to support the growth prospects. Unemployment in the region as a whole is also relatively low. Financial stability has generally been restored and there has been a resumption in credit growth.

The Financial Sector as an Enabler of Growth in Asia: The Vital Role of the Banking System in Facilitating the Economic Growth Process

The banking sector in particular and the financial sector in general have an important role in facilitating the growth process. The financial system in emerging market economies represents an important means to an end. For emerging market economies, the financial sector is an important enabler of growth. It is therefore important to embrace the long-term agenda of the economy.

Despite the trend of the increasing significance of alternative means of financing, the banking sector in emerging market economies will for some time to come remain the most important source of financing in the economy. The banking system therefore needs to effectively and efficiently perform its intermediation function. Of importance, is the need to recognise the on-going economic transformation that is taking place in the region and to facilitate a more balanced growth between domestic and external sources of growth, between public and private sector-led growth, between the balance of consumption and investment, and between the different sectors of the economy, regions and communities within the country. Facilitating a more balanced growth will contribute toward sustainability of the growth process.

With new areas of growth emerging, and new business models being adopted, new and more differentiated customer requirements need to be met. The level of innovation will need to be accorded increasingly important attention. While for the most part, pricing for products and services need to reflect the costs and risks, the industry needs to recognise that in emerging market economies, the basis to do so should take into account the social agenda that is an integral part of the sustainable performance of the country. The ability to achieve socio-economic stability will produce a more balanced growth. Ultimately, the objective of increasing competition and therefore enhancing efficiency in pricing needs to be balanced against providing basic financial services to the less advantaged retail customers at very minimal costs. Such trade-offs need to be made and managed.

This also includes enhancing access to financing to the various activities in the economy to both the large and small borrowers. In emerging market economies, providing other ancilliary financial services especially to small businesses will enhance the potential quality of such assets. This therefore, not only includes providing greater access to financing but the complete financial services solution to the small- and medium-sized enterprises. In addition, monitoring loan performance during the lifetime of the loan rather than only during the approval process will allow for early remedial action to be taken well before difficulties emerge.

A further important contribution in emerging market economies is to enhance consumer literacy through consumer and investor education to increase the potential for well-informed financial decisions. Another area that is important is the investment in human capital to create a workforce that is skilled and competent as this will bring substantial long-term benefits. Finally, foreign institutions that have a presence in the region need to recognise the meaningful role that can be realised in the region not only in meeting the requirements of the domestic environment but also to promote investment and business opportunities from their established networks in other parts of the world.

The Asian Financial Crisis not only presented the opportunity to improve the region's resilience to external shocks, but also underscored the importance of breadth in the financial sector, in particular, the development of alternative avenues of financing. Historically, bank loans, as well as funds raised through equity markets have assumed significant roles in Asia as the main sources of financing. By providing another avenue for financing with the development of the corporate bond market, firms are able to improve their ability to balance debt and equity to a manageable degree of leverage while reducing the impact of shocks arising from over-dependence on any single form or source of financing.

The development of corporate bond markets in the region has also enhanced the efficiency of capital allocation by providing **an avenue for investing one of Asia's hallmarks - its large reserve of savings arising from trade surpluses**. By developing the regional bond markets, it would enable firms to tap alternative sources of financing at competitive cost thereby contributing to increased efficiency, higher investment and consequently to overall growth.

The launch of the **Asian Bond Fund (ABF)** in June 2003 marks the first **significant step in regional financial co-operation and integration, and augurs well for the future development of the Asian regional bond market**. The Asian Bond Market will not only serve to facilitate the re-investment of a portion of Asia's reserves back into the region but what is equally important is that it allows for the efficient allocation of savings for productive investments and at the same time broaden and deepen the regional bond markets. In the process, the level of corporate governance in the region would be enhanced as well.

Indeed, developing such an alternative source of financing would serve as a more resilient source of long-term financing with improved currency and maturity matching of asset and liabilities. Finally, institutional investors with longer-term liabilities would benefit from reduced currency risk by purchasing longer-term bonds denominated in their home currency. This would contribute towards **diversifying risks arising from**

borrowing in foreign currencies, reducing the potential for systemic risk in the financial system.

At this juncture, there is still **much potential for improvement in the regional corporate bond markets**. Certain countries have taken measures to develop their bond markets with varying degrees of progress with efforts focused on strengthening the market infrastructure, establishing benchmark yield curves, augmenting the number of issuances and new instruments, and further liberalizing markets to enhance foreign participation.

This has resulted in the **evolution in the roles played by commercial banks**. In the process of developing corporate bond markets, commercial banks are becoming increasingly active as investment bankers, with roles as corporate advisors, major issuers, deal originators, underwriters, dealers, brokers and providers of a broad range of risk management and hedging instruments. Such an evolution follows the sequence in developing deeper, active and increasingly integrated and competitive financial markets.

In the pursuit to develop regional bond markets and options for raising capital, new mindsets of looking at regional and global capital markets and a broader range of tools in managing risk and hedging need to be adopted. In this environment regulators have directed efforts at increasing transparency, competition and strengthening the market and legal infrastructures. These efforts, coupled with Asia's history of enterprise and value creation augurs well for Asia as a region.

In conclusion, prospects for Asia continue to remain positive. Asia can expect to continue to remain the fastest growing region in the world. The economic and financial sectors in the region have now strengthened significantly and are better positioned to utilize the region's surplus capital to provide broader, deeper and more liquid sources of financing to facilitate the region's growth. The new emerging trends in the region point to increased economic and financial integration. This is reinforced by greater regional co-operation. All this would result in an Asia that is a more mutually-reinforcing region of growth. In the process, the Asian region would emerge as a stronger engine of growth, which in turn can facilitate more balanced growth in the world economy.

Second International Islamic Finance Conference
Crowne Plaza Hotel, Dubai, United Arab Emirates
22 September 2003
"Islamic Finance: Dynamic Industry in a Rapidly Changing Global Environment"
Keynote Address by
Tan Sri Dato' Sri Dr. Zeti Akhtar Aziz
Governor,
Bank Negara Malaysia

The Islamic financial industry is ascending to prominence in an environment that is highly competitive and constantly subject to the forces of change. The industry has made significant progress, with the essential fundamentals underpinning financial infrastructure to support its sound expansion in place. The challenge before us is to bring the industry to its next stage of development and reinforce the robustness of the industry in a more challenging environment. Of importance is the need to evolve the strategies that need to be adopted to build key strengths and enhance institutional capacity in the industry. Indeed, collaborative efforts need to be intensified on the global front and integration accelerated. As the decade unfolds, insha-Allah, the Islamic financial industry will evolve into an increasingly dynamic and vibrant industry.

It is my honour and pleasure to be here today at this Second International Islamic Finance Conference, organised by the Islamic Development Bank and the General Council of Islamic Banks and Financial Institutions. Globalization and financial liberalization have brought profound changes to our domestic and international financial landscape. These changes have been accompanied by an accelerating pace of financial liberalisation, driven by advances in technology. The advancements in information and communication technology have removed barriers in the market place.

Against this backdrop, Islamic banking and finance, which is still at its infancy, needs to be ahead of these developments in order to remain a viable and competitive form of financial intermediation. The challenge, therefore, in the Islamic banking industry, is to evolve the development of an Islamic financial system, into one which is dynamic, responsive and sustainable. As an intermediation process in this challenging environment, Islamic finance has been characterised by the powerful forces of change that have brought significant implications on both the domestic and global financial systems, and marked by turbulent financial conditions. This requires the development of robust and resilient Islamic financial institutions. Institutional capacity enhancement is a central strategy towards this objective. This requires having a high calibre workforce and management teams with the required expertise, leveraging on the technology, strengthening research and development, and instituting risk management systems. A structured consumer education programme needs to be in

place to enhance the awareness of the Islamic financial system and the advances it offers.

Towards this end, the development of an Islamic financial system would include the respective sets of the key components comprising the Islamic banking industry, the Islamic money and capital markets, and the takaful market, given the strong linkages, inter-dependence and synergies among these components in the system. Although the Islamic banking industry may be the core to an efficient Islamic financial system, it would need to have in place the supporting financial infrastructure. Of importance is the Islamic money market. The Islamic financial system also needs to include, at the early stage, the development of the Islamic capital market to provide an alternative source of financing, as well as to create broader and more diverse Islamic financial instruments for investors. Complementing these three components is Islamic insurance or takaful, that provides the necessary risk protection to its policy holders and to serve as an efficient mobiliser of long-term funds. In addition, the development of the non-bank financial intermediaries such as development financial institutions, savings institutions and housing credit institutions need to be developed to meet customer demands. These specialised institutions are important in meeting the requirements of the economy which are not met by the nascent Islamic banking institutions.

The spectrum of participants and the diversity of instruments are among the key attributes in creating the enabling environment for a dynamic Islamic financial system. This has been the approach adopted by Malaysia at the very onset of our journey in the development of a comprehensive Islamic financial system that is sustainable and progressive. In the initial stage during the early years of the development of the Islamic financial system, the focus of attention was on the development of the Islamic banking system and to expand the number of players and the volume of banking activity. This has increased significantly when the dual banking system was introduced. This was subsequently expanded to the specialised non-bank institutions, including the development financial institutions, and the savings banks and housing credit institutions, where Islamic financial products and services are being offered.

The other core components of the Islamic financial system comprised the Islamic money market, the Islamic capital market and the takaful market. Today, the Islamic money market has become an integral part of the Islamic financial system, with transactions of more than RM2 billion a day and a broad spectrum of instruments, among which included the Government Investment Issues, Bank Negara Negotiable Notes, Islamic accepted bills and the Islamic private debt securities. New ancillary players such as money brokers have facilitated the development of this market.

The Islamic capital market essentially comprises the equity market and the debt market. Phenomenal growth has been recorded in both these markets. In the debt market, the outstanding Islamic private debt securities as at-end June 2003 were RM68.2 billion or 36.9% of the total outstanding private debt securities. In 2002, the new issuance of Islamic debt securities (excluding Cagamas bonds) amounted to RM13.8 billion, surpassing the conventional private debt securities. In the equity market, more than 80% of the counters in the Kuala Lumpur Stock Exchange are Shariah-compliant. The takaful market has also shown impressive growth and the four takaful companies now offer a broad range of products in both family

and general business which is comparable to the conventional counterparts.

The Islamic financial system that has developed in Malaysia over the last two decades has emerged as a comprehensive Islamic financial system that operates in parallel with, and is able to compete on an even keel with the more entrenched conventional financial system. The development of Islamic finance as an important niche activity in Malaysia's International Offshore Financial Centre in Labuan also complements the development of the domestic Islamic financial market. To ensure the sound and stable development of the Islamic financial industry, it needs to be supported by a strong regulatory and supervisory framework. This is to ensure that the operations of the Islamic financial institutions are sound and not a source of vulnerability to the banking system. To a large extent, it has been governed by a regulatory framework that has been reinforced by the Shariah framework and the Islamic accounting standards.

The challenges facing the Islamic financial industry can be expected to be much more complex and demanding. This is because the regulatory framework in the Islamic financial industry needs to address the unique characteristics and attributes associated with Islamic banking operations and Islamic financial instruments. The complexities of the respective risks in the Islamic financial instruments need to be fully explored and quantified to provide for their effective assessment and management. With the advent of Basel II that advocates a higher degree of risk-focused regulatory approach, the Islamic financial institutions would be required to identify and "unbundle" the risks inherent in Islamic financial instruments. The players in the Islamic financial industry must therefore, have in place robust risk management practices and system.

In this regard, the establishment of the Islamic Financial Services Board has been timely. The IFSB has the important mandate of developing the prudential standards in accordance with the unique features of the Islamic financial institutions. Given that the IFSB and the existing standard setting body embraced common objectives, l do not see any difficulty in integrating the international standards with the Islamic prudential standards. This will contribute towards the development of a robust and resilient Islamic financial system that can effectively preserve financial stability and contribute to balanced growth and development. This will also facilitate the integration of the Islamic financial system as a viable component of the global financial system.

Over the years, the Islamic financial industry has adopted the adaptation approach in the formulation of Islamic financial products and services. Although there are Islamic financial instruments that are distinct from the conventional financial instruments, the numbers are still few. In most instances, the Islamic financial products are repackaged along the features of the conventional financial products, while eliminating the elements that are not in-compliance with the Shariah. While this adaptation can continue, the downside risk is that Islamic financial instruments will always have to "catch-up" with the pace of product development in the conventional system. Efforts should therefore be intensified to develop new financial products that embodied the virtues of Islamic banking. This would evolve Islamic financial instruments into distinct, innovative and cutting-edge products. Innovative instruments such as the sukuk have attracted interest from both the Islamic and conventional markets.

One of the central issues towards developing a dynamic Islamic financial industry is the

Shariah. The Shariah should always be viewed as an enabler to innovation and creativity, rather than a constraint. On the contrary, innovation and creativity is strongly advocated. Efforts therefore, need to be enhanced to fully appreciate and maximise the true potential and wisdom of Shariah. Thus, there is a need for greater collaboration among the Shariah scholars, practitioners and researchers to undertake in-depth studies and research to originate products. This would provide the fundamental foundation towards developing a dynamic Islamic financial system.

An issue that needs to be addressed is the scarcity of a pool of intellectual capital for Islamic finance. Further investment should be made in this area. In this regard, there is a need for Islamic financial players to intensify efforts in the training and development of expertise in the various specialised areas of Islamic finance. These programmes should be carried out in a comprehensive approach, encompassing both conventional banking and Islamic banking, complemented with Shariah knowledge. The dynamism of the Islamic financial industry can only be demonstrated through a pool of talent that possesses both convictions and expertise in Islamic finance.

Our quest to create a dynamic Islamic financial system is to achieve the ultimate objective for Islamic finance that will contribute significantly toward the overall development of our economies, through the intermediation process to facilitate trade and investment. Moving forward, it is the ability of the Islamic financial industry to build key strengths and enhance institutional capacity, intensify the collaborative efforts to strengthen the effectiveness of the Islamic financial infrastructure and the acceleration of its global integration that will provide the synergies and opportunities for the Islamic financial industry in the face of this more challenging environment. In doing so, Islamic finance can evolve into an important component of the international financial system that can contribute to enhance the prospects for balanced global growth and shared prosperity.

Institute of Islamic Banking and Insurance's International Conference on Islamic Insurance
London, United Kingdom
26 September 2003
"Building a Comprehensive Islamic Financial System: New Financial Opportunities"
Keynote Address by
Tan Sri Dato' Sri Dr. Zeti Akhtar Aziz
Governor,
Bank Negara Malaysia

Islamic banking and finance initially evolved as a form of financial intermediation for the Islamic community to conduct financial transactions that conform to Islamic tenets. Today, the Islamic financial industry has gained wider acceptance and appreciation and has expanded beyond the traditional borders of the Muslim-based economies into the major industrial economies to become an integral component of the global financial system.

In a global environment that has become increasingly challenging, an environment that is subject to the powerful forces of change, and that is characterized by volatile and unstable market conditions, Islamic finance has emerged as a competitive and resilient form of intermediation. Although Islamic finance is still at the early stage of development, it has experienced rapid expansion and is fast emerging as a viable and robust form of financial intermediation with significant potential.

It is indeed an honour for me to be here today before a distinguished gathering of scholars, researchers and practitioners of the takaful industry. I wish to take this opportunity to congratulate the Institute of Islamic Banking and Insurance for their efforts in organizing this international conference on Islamic insurance or takaful. The takaful industry represents an important component in the overall Islamic financial system given its role in the mobilisation of long-term funds, its role in providing risk protection, its role in the development of the Islamic capital market and as an important institutional investor, as well as its role in supporting the overall economic growth and development. Our challenge is thus to evolve a dynamic and vibrant takaful industry within the Islamic financial system. Of importance is the development of an Islamic financial system that is dynamic, responsive and sustainable.

The development of an Islamic financial system needs to include the respective components comprising the Islamic banking industry, the takaful industry, the Islamic capital and money markets, given the strong linkages, interdependence and synergies among these components in the system. The spectrum of participants and the diversity of instruments are among the key attributes in creating the enabling environment for a dynamic Islamic financial system. This has been the approach adopted by Malaysia at the very onset of our journey in the development of a comprehensive Islamic financial system that is progressive and sustainable.

In the initial stage during the early years of the development of the Islamic financial system, our focus of attention was on the development of the Islamic banking system and to expand the number of players and volume of activity. Following the introduction of the dual banking system, the pace of expansion increased significantly. In two decades, the total assets of the Islamic banking industry have increased from USD97 million at the outset to USD20 billion as at end-June 2003. Similar expansion also took place in the takaful industry whereby the assets have increased significantly from less than USD30 million in 1993 to USD1 billion in June 2003. The Islamic capital market in Malaysia also recorded significant growth whereby the outstanding Islamic private debt securities accounted for USD17.8 billion, or 36.9% of the total outstanding private debt market while the new issuance of Islamic private debt securities in the first eight months of 2003 amounted to USD1.7 billion. What is more encouraging is that more than one third of the new issuance of Islamic debt securities were issued by companies owned by non-Muslims, some of which includes multinational companies.

The evolution of an appropriate financial structure would need to take into account the role of the financial system in the economy and the objectives that need to be achieved. In the context of an emerging market economy, the financial system is a means to an end. The appropriate financial structure, particularly in emerging market economies, need to be designed to meet the requirements of the economy. The financial system needs to be in a position to support the real sector, changing and evolving with the changing needs of the economy. The strategy adopted in Malaysia is to develop a comprehensive Islamic financial system that is able to operate in parallel with the conventional financial system.

The key constituents within the Islamic financial system, which includes the Islamic financial institutions as well as the capital and money markets need to be firmly reinforced by the legal and regulatory framework that adequately address the unique characteristics of the industry. These intra-dependent key components ultimately form the enabling environment for the Islamic financial services industry to effectively play its role as an efficient conduit for mobilising resources and channelling them to productive purposes. The absence of any one of the components could reduce the effectiveness and efficiency and could affect the viability and sustainability of the system.

While the Islamic banking system plays an important role in mobilizing deposits and providing financing, the development of the capital market allows the corporate sector to source their long-term financing needs based on Islamic principles. In addition, it would increase the range of Islamic financial instruments available to meet the demand of the Islamic investors. In the absence of a comprehensive Islamic financial system with financial services based on Shariah principles, the development of Islamic banking and finance would be hindered.

The government would need to assume an important role in the development of the Islamic financial system. The role of the government is, amongst others to provide the enabling environment and put in place from the outset, the necessary infrastructure through the formulation of a comprehensive set of legal and regulatory framework for Islamic banking and finance. In addition, this framework needs to be reinforced by a Shariah framework to ensure that all financial transactions are Shariah-compliant. The operations would thus need to be not only based

on best practices, but also satisfy the tenets of the Shariah.

For Islamic banking and finance to be sustainable, compliance with Shariah principles alone is not sufficient. Over the long run, customers and businesses demand for quality in the products and services that Islamic finance offers. This is the challenge for Islamic banking and finance, to be able to provide a comprehensive range of Islamic financial products and services that are not only innovative and competitive but Shariah compliant.

Let me now turn to the development of the takaful industry. Takaful as a system of Islamic insurance, is based on co-operation and mutual help for the good of the society at large. Although takaful has been in the market for more than 20 years, it has yet to make significant inroads. It should however, be noted that although the conventional insurance market is deeply entrenched in several of the Muslim countries, the percentage of the Muslim population that are insured is relatively low. The market penetration level is very low, notably less than 5 per cent in many Muslim countries. In Malaysia, the level of market penetration in terms of takaful certificates in force over the total population is only 3.8 per cent compared to a market penetration for conventional insurance of 34.7 per cent. It therefore represents an enormous potential market that remains yet untapped.

Takaful operators assume an important role as economic or financial agents as they essentially mobilise long-term funds in the form of contributions and invest them in the available Islamic investment avenues. As custodians of public funds, takaful operators must ensure that the takaful funds are not only Shariah compliant but are soundly managed to instil confidence amongst the increasingly sophisticated public, particularly in terms of delivering the promise.

For the takaful industry to be developed into a viable alternative to the more entrenched conventional insurance industry, the need for it to be supported by the core components of a comprehensive Islamic financial system cannot be over-emphasised. As takaful operators are both mobilizers of long-term funds and fund managers to the policy holders, their ability to generate returns to fulfil the obligation to the policy holders depends very much on the range of financial instruments available in the market place.

Without an effective financial system, takaful operators may not be able to perform as effectively and as efficiently in terms of delivering their promise on the profit sharing basis and to be able to keep pace with their conventional counterparts in the area of fund performance. In the absence of a viable Islamic capital market, there would not be an adequate supply of quality financial instruments for which the takaful funds can invest. It may have to depend on low yielding returns from bank deposits. In addition, it will not be able to offer innovative products like investment linked products, which can further diversify their investment portfolio as these products are gaining popularity among conventional insurance companies. In the absence of an Islamic banking system, takaful operators would not be able to synergise and utilise the network of the banking system through bancassurance which can not only be an effective distribution channel but also serve to drive down operating costs.

The development of a comprehensive Islamic financial infrastructure in Malaysia that includes Islamic banking, the money and capital markets has reinforced the development of the

takaful business. Today, the takaful industry in Malaysia has emerged as a fast growing industry within the insurance sector since its introduction in 1985, 18 years ago. From total assets amounting to only USD0.5 million in 1986, it has reached more than USD900 million in 2002, constituting 5.2 per cent of the total assets of the insurance sector. In the same period, the takaful operators have offerred a wide range of family and general takaful products.

The Malaysian Financial Sector Master Plan represents the blueprint for the development of the financial sector over a 10-year period. The plan, which was launched in 2001, places importance on the development of Islamic banking and takaful sector as an important component in the financial system. To achieve this objective, emphasis is being given to financial infrastructure and institutional development, aimed at enhancing efficiency of the system and building the internal resilience and competitive position of the takaful operators, while meeting the needs of the nation. This includes providing the foundations for the development of the financial markets and strengthening the institutional development. As part of this process, the benchmarking exercise is an important tool to enhance performance and to guide the takaful operators on improvement of their business strategies. To reinforce this, a service quality index has also been initiated to promote the development of world-class products and services. This is also complemented with a comprehensive consumer education programme so as to promote product transparency and increase accountability. The introduction of financial advisers is also a further element to facilitate consumer access to a wider range of financial products.

Amongst the most imminent challenges is the creation of the critical mass in the market to allow for meaningful cross-border alliances at the regional and global level. The establishment of an adequate number of takaful operators in the market is also crucial to provide the groundwork for the setting-up of more retakaful operators, in terms of sustaining business support and providing the economies of scale in order for the retakaful industry to develop.

Currently there is still a dearth in the number of players providing the retakaful facility, resulting in takaful operators ceding to conventional reinsurers. While this has become a common practice, ideally more competitive retakaful operators who provide reinsurance in accordance with Shariah principles need to be established so that the takaful industry would not be dependent indefinitely on conventional reinsurance as the conduit to which they can mitigate risk. More importantly, retakaful operators ultimately serve to strengthen and enhance the financial capacity of the takaful industry, and the synergistic by-products emanating from the interactive business alliances would contribute towards the overall betterment and robustness of the Islamic financial system. Indeed, there is much to be gained by the takaful operators in particular, and the Islamic financial industry in general, by having access to an adequate and competitive market of the retakaful facility. It is therefore important to increase the collaborative efforts and examine plausible ways to address this gap in the takaful industry.

Our quest to create a dynamic Islamic financial system is to achieve the ultimate objectives of developing an Islamic financial system that will be able to contribute significantly to the overall development of our economy through the intermediation process. Thus, Islamic banking and finance industry needs to extend its agenda towards

the development of a comprehensive Islamic financial system. The Islamic banking and finance should strive to add value towards enhancing greater integration to the economy and the financial system. To harness the potential fully, genuine endeavours to develop and innovate Islamic financial instruments and activities that are able to fulfil the changing requirements of the economy and the emerging needs of the contemporary global marketplace need to be continuously pursued. Conferences such as this can contribute invaluable ideas to foster new initiatives towards the development of the Islamic financial system. With the acceleration of its global integration, it will provide the synergies and opportunities for the Islamic financial industry to evolve into an important component of the international financial system that can contribute to enhance prospects for balanced global growth and an enhanced shared prosperity.

Calendar of Events
July - September 2003

28 July 2003

The Bank hosted the ASEAN Anti-Money Laundering Workshop, which was organised as part of the commitment to the ASEAN Plan of Action to Combat Transnational Organised Crime. The workshop represented another important step towards regional financial co-operation to strengthen the regional defences against external shocks.

27 August 2003

The Bank announced that the Malaysian economy grew by 4.4% in the second quarter of 2003, culminating in a first half-year performance of 4.5%. The Bank also issued a Monetary Policy Statement for the first time.

29 August 2003

InsuranceInfo, the Consumer Education Programme for the insurance and takaful industries, was launched as part of the on-going efforts to promote market integrity and consumer protection over the whole spectrum of banking, insurance and takaful activities in the market.

29 August 2003

The Bank and the banking industry held their regular dialogue session to discuss economic and financial developments as well as the performance of the banking sector. The meeting also discussed bank lending, especially to small- and medium-scale enterprises and the Europay MasterCard Visa chip migration for credit cards. The meeting was also briefed on the progress of the proposed deposit insurance scheme and the activities of the Islamic Financial Services Board.

15 September 2003

As announced in the 2004 Budget, the Bank will issue the Bon Simpanan Merdeka (Merdeka Savings Bond) on a regular basis, with effect from February 2004. These bonds will provide an additional savings instrument that offers a more favourable rate of return to retirees. Subscription to these bonds will be opened to retirees who are not employed on a full-time basis, as well as uniformed personnel who are on mandatory retirement and not employed on a permanent basis.

18 September 2003

The Bank announced that it will issue up to three new Islamic banking licences to qualified foreign players as part of the overall efforts to strengthen the global integration of the domestic Islamic banking system. This step brings forward the liberalisation of the Islamic banking industry with respect to the issuance of new licences, to 2004, three years earlier than envisaged in the Financial Sector Masterplan.

23 September 2003

The Governor was named Asia's Best Central Bank Governor for 2003, by Euromoney Institutional Investors plc, a UK-based financial publication house, in a special edition of Emerging Markets, a Euromoney news bulletin. The

bulletin was distributed during the Annual Meetings of Boards of Governors of the World Bank and IMF held in Dubai, from September 17-24, 2003.

26 September 2003

The Islamic Banking and Takaful Expo 2003 was launched at the Putra World Trade Centre in Kuala Lumpur, in conjunction with the Islamic Banking and Takaful Week (26 September-2 October). It was aimed at enhancing the level of public awareness and knowledge of Islamic banking and financial services, and to boost the volume of Islamic banking and Takaful transactions.

29 September 2003

The Bank issued three commemorative coins in conjunction with the Langkawi International Maritime and Aerospace 2003 (LIMA '03) exhibition which was held from 30 September - 5 October 2003 in Langkawi.