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

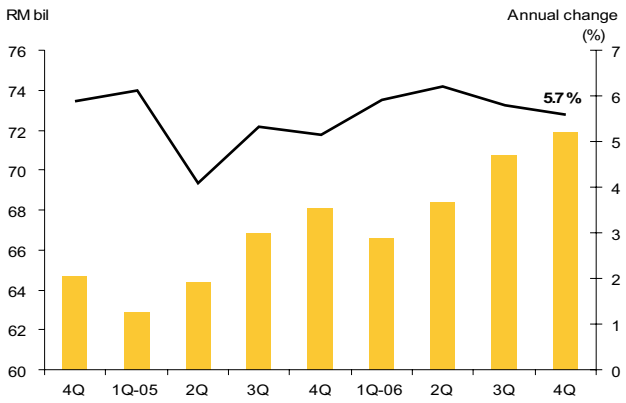
OVERVIEW

Sustained steady growth

The Malaysian economy continued to sustain steady growth in the fourth quarter, with real gross domestic product expanding by 5.7% in the quarter (3Q: 5.8%). The expansion was more broad-based with all sectors of the economy now recording positive growth. Underpinned by stronger consumer sentiment and sustained business confidence, the private sector was the main contributor to growth which was supported by the external and public sectors. For the whole year, real gross domestic product (GDP) expanded by 5.9%.

The services and agriculture sectors continued to expand strongly at a rate faster than the overall economy. Led by consumption, tourism, finance and business activities, the services sector expanded by 7% in the fourth quarter. In particular, the finance, insurance, real estate and business services; and the transport, storage and communication sub-sectors performed favourably. Growth in the agriculture sector strengthened to 6.5% underpinned by the strong performance of crude palm oil and rubber, and to a lesser extent, food output, in particular, fish and livestock.

Sustained Growth in 4Q 2006



The more diversified base of the manufacturing sector provided support for value added to continue to expand by 4.3% in the fourth quarter (3Q: 7.2%). Growth of the electronic and electrical (E&E) and the chemical industries moderated as external demand for laptops, computers and plastics moderated. On the other hand, strong external demand for resource-based products supported the growth of the rubber, wood and petroleum industries. As a group, export-oriented industries registered a growth of 4.3% (3Q: 5.9%). The domestic–oriented industries continued to record double-digit growth of 11.1% (3Q: 12.2%). The performances of the construction-related, fabricated metal and food industries were strong, supported by domestic and external demand.

The mining sector expanded by 1.9%, supported by higher output of crude oil (including condensates) and natural gas. The construction sector recorded positive growth for the first time after ten consecutive quarters of decline, supported by increased activity in the civil engineering sub-sector with the gradual commencement of projects under the Ninth Malaysia Plan. The non-residential sub-sector also continued to expand driven by strong demand for new retail space amidst favourable business activities.

Domestic demand strengthened further in the fourth quarter, registering a growth of 7.5%. Gross fixed capital formation recorded a robust growth of 9.8% during the quarter. Investment spending by the public sector increased in line with the higher disbursement of Federal Government funds for on-going

projects, new development starts and the provision of public services and utilities. Private sector capital spending remained strong spurred by the resilient business outlook and sustained high capacity utilisation. Imports of capital goods and loans approved to businesses, especially in the manufacturing and construction sectors, were supportive of the upward trend in private investment activities. Private consumption also remained strong, increasing by 6.6%, supported by the steady increase in household disposable income, year-end bonus payments and favourable commodity prices. Meanwhile, public consumption increased by 6.9% due mainly to higher expenditure on emoluments.

For the fourth quarter, headline inflation, as measured by the Consumer Price Index (CPI), moderated further to 3% (3Q: 3.6%), in line with market and official expectations. The lower inflation rate was broad-based with all the major categories of the CPI basket registering slower inflation rates. Demand-induced inflation was relatively subdued during the quarter. For the year as a whole, the headline inflation rate averaged at 3.6% (2005: 3.0%). In the labour market, conditions continued to remain stable supported by the gains in labour productivity.

On the external front, the trade surplus amounted to RM30.4 billion (3Q: RM29.4 billion). Gross exports increased by 6.6%, supported by the stronger expansion in agricultural exports (22.8%) and moderate expansion in manufactured exports (5.7%). The expansion in manufactured exports was weighed down by the lower demand for selected exports of E&E. In contrast, exports for telecommunication equipment and resource-based products continued to perform favourably. The expansion in agriculture exports was supported by crude palm oil and rubber. The robust performance in palm oil exports was on account of significantly higher volume (21.4%) and price which increased by 14.7% following the significant increase in demand from PR China, EU and the US. The growth in rubber exports of 12.7% was on account of price, which increased by 11.1%. Receipts from mineral exports increased by 2.5% due mainly to higher exports of liquefied natural gas, which rose by 10.7% supported by higher prices. Meanwhile, crude oil exports declined. The export price of crude oil averaged USD63.50 per barrel in the fourth quarter (3Q: USD72.10).

Gross imports increased by 6.6%. The increase was also across all categories of imports, namely intermediate goods by 6.7%, capital goods by 4.6% and consumption goods by 12.1%.

In the financial account, foreign direct investment (FDI), as monitored by Bank Negara Malaysia's Cash BOP system, recorded a larger net inflow of RM12 billion. These inflows were broad based and channelled mainly into the manufacturing, oil and gas, and services sectors. The FDI data on cash basis captures new financial flows and does not include retained earnings and investment in the form of imported machinery and equipment. During the quarter, there was a net inflow of portfolio investment amounting to RM7.8 billion. For overseas investment, there was a net outflow of RM1.4 billion.

The international reserves of Bank Negara Malaysia amounted to RM290.4 billion (USD82.5 billion) as at 31 December 2006. As at 15 February 2007, the reserves amounted to RM299.8 billion (USD85.1 billion), sufficient to finance 8 months of retained imports and was 6.6 times the short-term external debt.

Monetary policy remained supportive of economic activity

With inflation trending downwards, amid indications that the Malaysian economy would continue to expand at a steady pace, the Overnight Policy Rate (OPR) was maintained at 3.50% throughout the fourth quarter.

Reflecting the unchanged OPR, interbank rates of all maturities remained stable during the quarter. Retail lending and deposit rates also remained relatively unchanged. Of significance, the real fixed deposit rates for all maturities turned positive in October as inflation moderated.

Banking system loans and private debt securities (PDS) outstanding expanded at a combined annual rate of 6.2% at end-4Q (end-3Q: 7.9%). Banking system loans outstanding increased at an annual rate of 6.3% (3Q: 7.5%). Loans outstanding to businesses expanded by 4.2% (3Q: 3.3%). Business loan applications and approvals registered strong growth rates during the quarter in line with the stronger performance of the construction sector and the domestic construction-related manufacturing industries. Loans outstanding to households grew at a slower annual rate of 9.4% (end-3Q: 11.4%).

The public and private sectors raised a higher amount of net funds, totaling RM7.5 billion (3Q: RM3.8 billion) through the capital market during the quarter. Excluding Cagamas, gross funds raised from the PDS market remained substantial at RM8.1 billion (3Q: RM7.9 billion). The funds were mainly raised through the issuance of medium-term notes, which accounted for 58% of total PDS issued. After adjusting for redemptions, the net funds raised through the PDS market, excluding Cagamas, amounted to RM2.4 billion, matching the amount in 3Q.

Both M1 and M3 growth remained on an upward trend. M1, or narrow money, grew by 13.8% on an annual basis (3Q: 11.5%), reflecting both the higher demand deposits placed by business enterprises and the higher amount of currency held by the private sector. M3, or broad money, increased at an annual rate of 12.3% (3Q: 7.9%).

The ringgit appreciated against the G3 currencies, as well as against most regional currencies in the fourth quarter, particularly in December. The ringgit appreciated against the US dollar as portfolio flows returned to emerging markets, amidst renewed positive investor sentiment towards regional economic prospects. In December 2006, there was limited contagion impact on the ringgit arising from the regulatory measures imposed on 18 December 2006 by the Bank of Thailand.

The ringgit continued its appreciating trend in 2007, as with most regional currencies during the period. For the period 3 January – 28 February 2007, the ringgit appreciated against all major currencies and recorded a mixed performance against regional currencies, appreciating against the Indonesian rupiah (2.8%), Korean won (1.8%), Taiwan dollar (1.8%) and Singapore dollar (0.5%), but depreciating against the Thai baht (0.9%) and remaining relatively unchanged against the Chinese renminbi and Philippine peso.

The banking system remained strong

The banking system remained strong in the fourth quarter. As at end-December, the risk- weighted capital ratio (RWCR) stood at 12.8%. Pre-tax profit for the quarter amounted to RM4.4 billion. During the quarter, fee income attained from corporate advisory and remittance services and net trading and investment income were higher. The level of non-performing loans (NPLs) of the banking system continued to improve, attributed mainly to higher recoveries and reclassification of NPLs to performing status. As a result, the net NPL ratio declined further to 4.8% based on the 3-month classification (3Q: 5.1%).

The Malaysian economy is expected to maintain a steady growth path in 2007

Going forward, global economic expansion is expected to be sustained at above 4% in 2007. While there may be some moderation in the external sector, it is expected to be modest. The broader US economy is expected to sustain its underlying growth despite some weakness in the housing and automotive sectors. There will however, be more broad-based global growth with the strengthening of recovery in Japan, the improved growth prospects in the Euro area and the sustained growth in the Asian region. The economic growth prospects for

Malaysia is expected to remain favourable for 2007. While any moderation in the external economic conditions can affect the export sector, domestic demand, including both the private sector and public sector activity is expected to support the growth momentum of the Malaysian economy. Sustained private consumption and continued expansion in investment activity are expected to provide solid support for the growth. This will be reinforced by the implementation of the Ninth Malaysia Plan projects which have already commenced in the fourth quarter of 2006.

The diversified economic structure and the strengthened macroeconomic fundamentals, the more developed domestic financial markets and the sound financial sector are important factors that continue to support Malaysia's economic flexibility and resilience to withstand external shocks. The developments in these two days in the global, regional and domestic financial markets reflect the potential for contagion. As a highly open and liberalized economy, Malaysia is not insulated from these developments. While the financial markets can be expected to experience volatility from time to time, the resilience of the underlying domestic economy continues to be the fundamental factor that will support the performance of the financial markets.

The strong corporate balance sheets and the favorable prospects for the economy remain important factors that will support this trend. Of greater significance, these external developments that have occurred in these two days have not had any material impact on the other domestic financial markets. Relatively stable conditions have prevailed in the foreign exchange market with two way flows moderating any significant movements in the market. The impact on the bond market has also been negligible, demonstrating the depth and maturity of the market. Thus, the preconditions prevailing in Malaysia would continue to support the growth momentum of the Malaysian economy.

DEVELOPMENTS IN THE FOURTH QUARTER OF 2006

INTERNATIONAL ECONOMIC ENVIRONMENT

Sustained growth in major economies

Global economic activity broadened in the fourth quarter with higher growth in the United States, continued recovery in Japan, rising growth momentum in Europe and sustained strong expansion in the Asian region.

The **US** economy expanded more rapidly in the fourth quarter of 2006, growing by 3.5%, driven largely by stronger consumption. Healthy job creation, rising wages and easing gasoline prices supported consumer spending. Following the lower crude oil prices, the trade deficit improved. Meanwhile the weaker dollar and firm foreign demand spurred export performance. There were also signs of stabilisation in the housing market, with new and existing home sales declining at a slower pace and the pending home sales index recording the biggest monthly gain since 2004. Investment activity related to the residential property and transportation equipment sectors, however, remained weak.

In **Japan,** the economy expanded strongly by 4.8% in the fourth quarter of 2006, supported mainly by a rebound in private consumption. Furthermore, corporate capital spending expanded significantly and exports continued to increase, albeit at a moderate pace. In the **Euro area,** 4Q growth was lifted by improved performance in Germany, Italy and France. Euro area economic activity strengthened with the expansion in exports and higher growth in private consumption, amid an improving labour market. Germany's broad-based recovery also emerged as a stronger driver of euro area growth. Labour market improvements were evident with unemployment rates on a downward trend in Germany, France and Italy. Overall sentiments were improving with upward trends registered by the Zew, Ifo and economic sentiment indicators. Meanwhile in the **UK,** GDP expanded by 3% in the fourth quarter, supported mainly by continued expansion in the services sector.

Industrial countries: Real GDP Growth

	2005		2006			Key contributing factors for 4Q growth
	4Q	Year	3Q	4Q	Year	
	Annual change (%)					
US[1]	1.8	3.2	2.0	3.5[a]	3.4	Growth rebounded to grow at about potential output, supported by strong consumer spending and improved trade deficit despite continued weakness in the auto and housing sectors.
UK	2.0	1.9	2.9	3.0	2.7	Supported mainly by the services sector especially business services and finance.
Euro zone	1.8	1.4	2.8[r]	3.3	2.7	Growth appeared to be broad-based with continued expansion in exports and domestic demand.
Japan[1]	1.7[r]	1.9	0.3[r]	4.8[p]	2.2	Rebound in private consumption and robust private non-residential investment Growth in exports provided more support to underpin continued recovery for the economy.

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

Source: National authorities

Major central banks maintained their tightening bias in **monetary policy**. The **FOMC** continued to maintain interest rates at 5.25% for the fifth consecutive meeting on 31 January 2007 in view of potential risk to inflation arising from the high level of resource utilisation in the economy. The **Bank of Japan** increased the uncollateralized overnight call rate by 25 bps to 0.5% on 21 February 2007, citing that trends in consumer prices are likely to increase in the long run. Both the **European Central Bank** and the **Bank of England** maintained their interest rates in February at 3.5% and 5.25% respectively.

Global **crude oil prices** experienced the most significant correction in over 15 years, declining by nearly 20% from the peak in mid-July (USD78.40 per barrel) to average USD60.18 p/b in the 4Q. The decline in prices was supported by easing geopolitical concerns, rising crude inventories, the mild hurricane season in the US and a warmer-than-expected winter in the US Northeastern region.

In the **Asian region,** economic growth in the fourth quarter remained robust. Growth was led by China, and supported by continued strength in exports and domestic demand. Despite the moderation in US growth, regional exports as a whole remained resilient with many regional countries reporting double-digit growth.

Inflationary trends were mixed in the fourth quarter. Inflation in PR China and some of the NIE countries trended up slightly due to rising food costs. Easing crude oil prices however, led to lower inflation in the ASEAN-4 countries. Of significance, Indonesia recorded a sharp dip in inflation, as effects from the removal of fuel subsidies in the fourth quarter of 2005 began to recede. This has prompted the Indonesian authorities to cut interest rates throughout the quarter. Meanwhile, India raised interest rates to curb inflationary pressures emerging from strong domestic demand.

In the **foreign exchange market,** the US dollar ended the year mixed against major currencies. The dollar depreciated against the **euro** and **sterling** on expectations of higher interest rates in both the eurozone and the UK. On 24 November, the euro broke above USD1.30 against dollar for the first time in 1 ½ years. The weakness in the dollar was also driven in part by concern over foreign central banks diversifying their foreign reserves, narrowing interest rate differentials between the US and other parts of the world and to some extent, the softer US economic data. The dollar appreciated against the **yen,** breaking above the 120 level on 11 January 2007 following reduced expectations of an interest rate hike after data suggested that Japanese consumption and consumer prices had softened towards the end of the year. Meanwhile, all the regional currencies strengthened during the fourth quarter compared to the end of the third quarter. The **Thai baht** recorded the strongest appreciation, following the strong capital inflows. The rapid strengthening of the Thai baht and surging capital inflows prompted the Thai authorities to enact capital controls on 18 December 2006. Parts of the measures were however subsequently relaxed.

Regional Countries: Real GDP Growth

	2005		2006			Key contributing factors for 4Q growth
	4Q	Year	3Q	4Q	Year	
	Annual change (%)					
PR China	9.9	10.4	10.6	10.4	10.7	Driven by strong exports and investments.
Singapore	8.3	6.6	7.0	6.6	7.9	Supported by manufacturing, wholesale & retail as well as financial services sectors.
Indonesia	4.9	5.6	5.9	6.1	5.5	Supported by the telecommunication and transportation sector, investment and exports.
Philippines	5.3	5.0	5.3	4.8	5.4	Supported by exports while agriculture sector registered slower growth.
Korea	5.3	4.0	4.6	4.0	5.0	Supported by the manufacturing and services sectors.
C Taipei	6.4	4.1	5.0	4.0	4.6	Driven by private consumption and investment.

Source: National authorities

DEVELOPMENTS IN THE MALAYSIAN ECONOMY

Broad-based economic expansion

Real GDP growth increased by 5.7% during the fourth quarter of 2006 reflecting expansion in all major economic sectors. In particular, the growth was led by strong expansion in the services and agriculture sectors, and reinforced by the turnaround in the mining and construction sectors. The services sector was supported by consumption, tourism, finance and business activities, while growth in the agriculture sector was led by higher palm oil output. The turnaround in the mining sector was due to higher output of crude oil and natural gas. The construction sector expanded for the first time after ten consecutive quarters of decline due to improved performance in the civil engineering and the non-residential segments. Meanwhile, the manufacturing sector recorded a more moderate expansion due to slowdown in the export-oriented sector.

Quarterly GDP by Kind of Economic Activity at 1987 Prices

	2005		2006		
	4Q	Year	3Q	4Q	Year
	Annual Change (%)				
Agriculture	-1.5	2.5	6.2	6.5	6.4
Mining	-2.0	0.8	-0.4	1.9	-0.2
Manufacturing	7.9	5.1	7.2	4.3	7.0
Construction	-0.6	-1.6	-0.4	0.6	-0.5
Services	5.9	6.5	6.4	7.0	6.5
Real GDP (Ann. Chg.)	**5.2**	**5.2**	**5.8**	**5.7**	**5.9**
Real GDP (Preceding Chg.)	**1.8**	**5.2**	**3.4**	**1.7**	**5.9**

Source: Department of Statistics, Malaysia

Services sector remained strong

The **services sector** continued to expand at a faster pace than the overall GDP growth at 7% (3Q: 6.4%). Growth was supported by consumption activity due to the major festivities, holiday season and year-end sales, while the strong promotional campaigns in preparation for the 2007 Visit Malaysia Year resulted in increased tourist arrivals especially towards the year-end. Given these developments, the **wholesale and retail trade, hotels and restaurants** sub-sector expanded by 5.2% (3Q: 5.8%). The automotive trade industry, however, remained lacklustre due to the weakness in the second-hand car market.

Increased domestic travelling during the festival and holiday season also supported the transportation sector during the quarter. This was further enhanced by the special promotions offered by the domestic airline companies which induced domestic tourism. Meanwhile, the telecommunications sector continued to expand led mainly by the cellular segment due to higher usage of the data and voice services in response to the promotions offered by the service providers. Consequently, the **transport, storage and communication** sub-sector expanded by 6.8% (3Q: 7.1%).

Growth in the services sector was also underpinned by increased finance and business activities, particularly in the new growth areas. This was reflected in the **finance, insurance, real estate and business services** sub-sector, which expanded by 8.3% (3Q: 7.4%). Growth was supported by lending activities and increased revenue from fee-based income

Performance in the Services Sector (Value Added)

	Share 2005	2005		2006		
		4Q	Year	3Q	4Q	Year
	%	Annual change (%)				
Intermediate Services	**41.5**	**5.5**	**5.9**	**7.3**	**7.8**	**6.8**
Transport, storage & communication	15.1	4.9	6.2	7.1	6.8	6.3
Finance, insurance, real estate & business services	26.4	5.8	5.7	7.4	8.3	7.1
Final Services	**58.5**	**6.1**	**6.9**	**5.8**	**6.5**	**6.3**
Electricity, gas & water	7.1	3.7	5.6	5.2	6.7	4.9
Wholesale & retail trade, hotels & restaurants	25.2	7.0	8.0	5.8	5.2	5.9
Government services	12.8	7.4	7.6	7.9	10.8	9.6
Other services	13.3	4.6	4.9	4.2	4.7	4.5
Total Services	**100**	**5.9**	**6.5**	**6.4**	**7.0**	**6.5**

Source: Department of Statistics, Malaysia

in both the conventional and Islamic finance. Insurance activity remained high underpinned by increases in the medical and health insurance products as well continued strong performance of the investment-linked products. The, real estate activity was also higher, while business services benefited from the favourable stock market performance and rapid expansion in the IT related businesses. During the quarter, 112 new MSC-status companies came into operation (3Q: 66 companies).

Selected Quarterly Indicators in the Services Sector

	2005		2006		
	4Q	Year	3Q	4Q	Year
	Percentage at end-period (%)				
Cellular phone penetration rate	74.1	74.1	81.6	72.3	72.3
Internet subscribers penetration rate	13.9	13.9	14.0	14.0	14.0
Broadband subscribers penetration rate	1.9	1.9	2.8	3.3	3.3
	Annual change (%)				
Total passenger traffic at all airports	1.9	4.8	0.0	0.2	2.2
Total consumption credit outstanding	18.7	18.7	18.0	14.9	14.9
Loan outstanding to the wholesale & retail trade, restaurants & hotels	8.3	8.3	10.9	12.0	12.0
Imports of consumption goods	4.2	5.9	14.7	12.1	13.4
Total sales of passenger cars	13.6	8.9	-7.0	-26.0	-12.4
Total sales of commercial vehicles	16.5	31.4	-15.0	-20.6	-7.1
SMS traffic	156.3	130.8	36.6	32.1	51.6
Cargo handled (all airports)	6.2	4.3	5.4	1.5	5.7
Container cargo handled (Port Klang and PTP)	7.8	4.9	15.9	18.7	14.2
Cargo revenue (Railway)	-2.9	-1.5	8.2	12.3	5.1

Source: Various sources

The **utilities** sub-sector recorded a higher growth of 6.7% (3Q: 5.2%), due to higher generation of electricity to meet the demand by commercial users during the year-end sale promotion, while the **Government services** continued to expand, reflecting increases in emoluments, including allowances and bonuses paid to the civil servants.

Expansion in manufacturing activity led by domestic-oriented industries

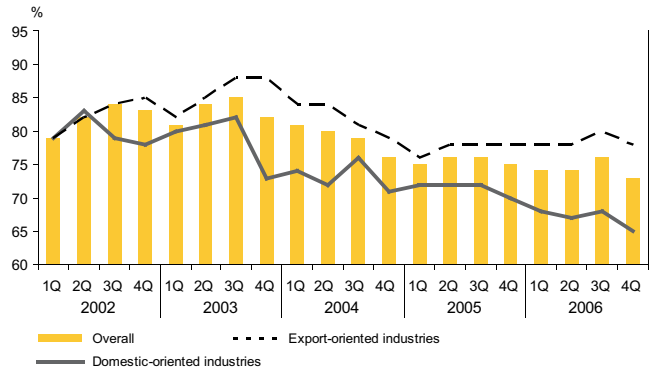
The **manufacturing sector** continued to expand by 4.3% in the final quarter of 2006 (3Q: 7.2%). Growth was supported by export-oriented industries and strong performance in the domestic-oriented industries.

The **export-oriented industries** expanded by 4.3% (3Q: 5.9%) as the electronics and electrical industry was affected by the slower demand for the computer segment from the US market. Nevertheless, demand for selected resource-based products was sustained at a high level. Of significance, rubber products grew at a double-digit growth supported by continued expansion in the gloves segment and improvement in tyre industry. Stronger external demand and favorable export prices led to the expansion in wood products, while activity in the off-estate processing industry was sustained in line with the trends in crude palm oil production. Meanwhile, performance of the chemical industry was subdued due to slower demand for plastic bags following some build-up in stocks in the European Union as well as slower growth in the industrial gas segment.

The **domestic-oriented industries** expanded by 11.1%; (3Q: 12.2%), driven mainly by the higher production of construction-related materials and further supported by the fabricated metal and food products. Output of construction-related industries (such as iron and steel, cement and glass products) was underpinned by both domestic and external demand. The transport equipment industry, however, contracted further (-11.5%; 3Q: -2.6%), as demand for new passenger cars remained weak due to the weakness in the low resale value of second hand cars.

The **overall capacity utilisation rate** of the manufacturing sector averaged 73% in the 4Q (3Q: 76%), with the export-oriented and domestic-oriented industries operating at 78% and 65% respectively (3Q: 80% and 68% respectively).

Capacity Utilisation in the Manufacturing Sector



Performance in the Manufacturing Sector

	2005		2006		
	4Q	Year	3Q	4Q	Year
	Annual change (%)				
Value Added (Constant Price)	**7.9**	**5.1**	**7.2**	**4.3**	**7.0**
Overall Production	**8.2**	**5.1**	**7.1**	**5.6**	**7.6**
Export-oriented industries	**10.1**	**5.7**	**5.9**	**4.3**	**7.6**
Of which:					
Electronics and electrical	10.5	3.5	5.1	2.5	8.0
Electronics	13.1	5.2	8.8	5.0	11.9
Electrical	3.7	-0.8	-5.5	-4.7	-2.7
Chemicals and chemical products	16.8	11.0	-1.8	-2.2	2.8
Petroleum products[1]	11.5	10.8	18.1	13.1	13.7
Textiles, wearing apparel & footwear	10.3	3.4	-0.8	0.9	5.9
Wood and wood products [2]	3.1	1.5	4.2	12.4	4.5
Rubber products	-1.6	-0.4	13.5	14.4	7.0
Off-estate processing	-4.6	8.1	9.7	9.4	5.6
Domestic-oriented industries	**0.4**	**2.8**	**12.2**	**11.1**	**7.5**
Of which:					
Non-metallic mineral products	1.5	2.0	8.1	8.8	3.2
Iron & steel and non-ferrous metal	-13.4	-5.3	7.9	25.7	4.2
Food	4.8	7.6	14.4	9.6	6.6
Transport equipment	6.7	8.5	-2.6	-11.5	-0.9
Fabricated metal products	-5.7	-4.9	36.1	32.0	27.0
Total Manufactured Exports	**13.0**	**10.0**	**14.2**	**5.7**	**10.1**
Of which:					
Electronics and electrical products	14.7	9.9	10.3	1.7	6.4
Chemicals and chemical products	4.5	6.8	22.0	17.9	10.8
Petroleum products	20.6	24.7	32.0	3.1	27.3
Wood and wood products	7.1	2.1	34.3	26.8	16.7
Furniture & parts	2.9	6.6	10.5	7.6	7.9
Rubber products	18.7	11.6	48.5	31.9	34.6

[1] Under the new Industrial Production Index (2000=100), LNG has been reclassified as petroleum products (previously classified as chemicals and chemical products). Consequently, petroleum products have been reclassified as export-oriented industries.

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

Source: Department of Statistics, Malaysia

Commodities sector supported by strong agriculture output and expansion in the mining activities

Growth in the agriculture sector strengthened to 6.5% in the 4Q (3Q: 6.2%), led by the industrial crops namely crude palm oil and rubber, as well as expansion in selected other sub-sectors. Meanwhile, the mining sector turned around to register a growth of 1.9% (3Q: -0.4%), supported by higher output of crude oil (including condensates) and natural gas.

In the **agriculture sector**, crude palm oil output was sustained at a high level of 4.1 million tonnes (3Q: 4.5 million tonnes) representing a growth of 10.7%, even though output traditionally moderates in the last quarter of the year. This was due entirely to better yield performance. Fresh fruit bunches (FFB) rose to 5.03 tonnes per hectare (4Q 2005: 4.76 tonnes per hectare) and the oil extraction rate (OER) improved to 20.5% (4Q 2005: 20.2%). Growth in natural rubber output rose by 7.7% (3Q: 7.8%), as smallholders who account for almost 95% of total output continued to tap intensively, motivated by high prices. Although prices have somewhat tapered from the exceptionally high levels seen in the earlier months (608 sen per kilogramme compared with above 700 sen per kilogramme), smallholders continued to use high-yielding technologies such as the Low Intensity Tapping System (LITS) to increase yields.

Performance in the Agriculture Sector

	2005		2006		
	4Q	Year	3Q	4Q	Year
	Annual change (%)				
Value Added (at 1987 prices)	**-1.5**	**2.5**	**6.2**	**6.5**	**6.4**
Production[1]					
Of which:					
Crude palm oil	-6.0	7.0	10.6	10.7	6.1
Crude palm kernel oil	-5.4	12.1	11.5	14.7	6.1
Rubber	-3.5	-3.7	7.8	7.7	11.9
Saw logs	3.6	1.6	-1.3	1.6	-4.2
Cocoa	-7.8	-16.3	17.8	-19.9	14.2
Exports (RM million)	**-0.3**	**0.6**	**19.7**	**22.8**	**12.7**
Of which:					
Palm oil					
('000 tonnes)	-4.9	7.0	11.4	21.4	7.4
(RM/tonne)	-8.5	-14.6	11.0	14.7	6.1
(RM million)	-13.0	-8.7	23.7	39.3	13.9
Palm kernel oil					
('000 tonnes)	-2.1	16.9	36.2	41.2	-4.0
(RM/tonne)	-12.4	-0.3	-15.8	-4.5	-14.6
(RM million)	-14.2	16.5	14.7	34.8	-18.0
Rubber					
('000 tonnes)	-0.2	1.8	-4.1	1.4	1.3
(Sen/kilogramme)	28.7	9.2	59.5	11.1	40.5
(RM million)	28.4	11.2	53.0	12.7	42.3
Sawn timber					
('000 cu.metres)	6.7	16.5	-8.0	-7.5	-12.8
(RM/cu.metre)	12.6	-1.8	17.9	9.6	20.3
(RM million)	20.2	14.4	8.4	1.4	4.8
Saw logs					
('000 cu.metres)	-4.9	8.4	-21.7	-3.2	-17.1
(RM/cu.metre)	17.5	6.4	7.7	7.2	10.7
(RM million)	11.8	15.4	-15.6	3.8	-8.3
Cocoa beans					
('000 tonnes)	-5.6	-1.4	321.3	-8.2	45.8
(RM/tonne)	3.5	-2.4	4.4	10.2	3.7
(RM million)	-2.3	-3.9	339.9	1.1	51.2

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

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

In addition, the food-related activities, particularly fish, livestock, fruits and vegetables also contributed to the growth during the quarter. The output was supported by the increase in domestic demand during the major festivals. Fish landings rose strongly, due to increase in output of marine fish and strong growth in aquaculture, while livestock activity was supported by domestic demand for poultry.

The **mining sector** was supported by higher output of natural gas (4.4% to 6,085 million standard cubic feet) and crude oil (including condensates) which rose marginally by 0.3% to 729,013 barrels per day.

Performance in the Mining Sector

	2005		2006		
	4Q	Year	3Q	4Q	Year
	Annual change (%)				
Value Added (at 1987 prices)	**-2.0**	**0.8**	**-0.4**	**1.9**	**-0.2**
Production					
Of which:					
Crude oil and condensates	-6.1	-8.0	-2.1	0.3	-0.5
('000 barrels)					
Natural gas (net)	-0.6	11.3	3.5	4.4	-0.4
(million standard cubic feet)					
Exports (RM million)	**21.1**	**26.4**	**3.2**	**2.5**	**9.2**
Of which:					
Crude oil and condensates					
('000 tonnes)	8.7	-1.8	-11.1	-7.6	-7.9
(USD/barrel)	26.3	35.6	16.7	4.3	21.3
(RM million)	36.4	32.6	1.0	-7.5	8.2
Liquefied natural gas					
('000 tonnes)	-0.8	6.9	1.8	1.8	-1.9
(RM/tonnes)	18.4	13.1	13.0	8.7	14.2
(RM million)	17.4	21.0	15.0	10.7	12.0

Source: PETRONAS
Department of Statistics, Malaysia

Positive growth in construction sector

The **construction sector** turned around to register a growth of 0.6%. The improved performance was led by the civil engineering sub-sector following the gradual commencement of projects under the Ninth Malaysia Plan. This positive development was further supported by the strong interest in the non-residential sub-sector, in particular construction activities for new supply of retail space. Meanwhile, the residential segment continued to be supported by demand in a number of prime locations and high-end property.

Construction Indicators

	2005		2006		
	4Q	Year	3Q	4Q	Year
	Annual change (%)				
New sales and advertising permits	11.4	15.9	-21.7	-2.7	-17.6
Housing approvals	2.8	-2.7	-12.6	-20.0	-23.2
Production of construction-related materials	-3.8	-0.5	8.0	14.2	3.5
Loans approved for construction	3.4	2.2	8.0	73.2	13.0
Imports of construction materials and mineral products	0.2	-7.3	38.3	-10.8[1]	8.8[2]

[1] Oct-Nov 2006
[2] Jan-Nov 2006

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

Domestic demand strengthened further

Domestic demand strengthened further in the fourth quarter to record an annual growth of 7.5% (3Q: 6.8%), driven mainly by private sector expenditure. Meanwhile, the public sector continued to remain supportive of growth.

GDP by Expenditure Components (at constant 1987 prices)

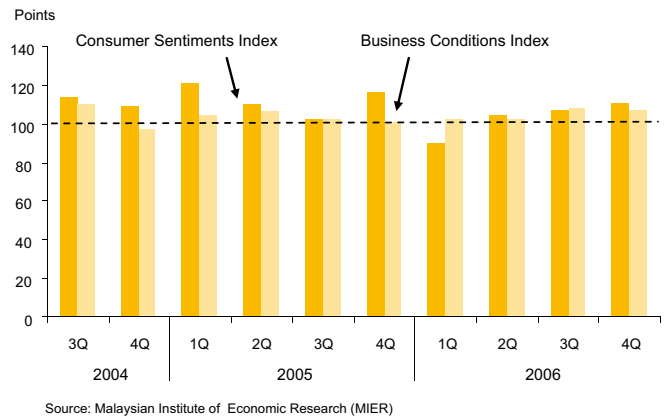
	2005		2006		
	4Q	Year	3Q	4Q	Year
	Annual change (%)				
Aggregate Domestic Demand (excluding stocks)	7.2	7.3	6.8	7.5	7.4
Consumption	9.9	8.3	8.2	6.7	7.2
Private sector	*9.0*	*9.2*	*6.8*	*6.6*	*7.0*
Public sector	*12.6*	*5.4*	*13.0*	*6.9*	*7.9*
Gross Fixed Capital Formation	0.4	4.7	3.5	9.8	7.9
Exports of Goods and Services	9.7	8.6	10.5	4.1	6.3
Imports of Goods and Services	8.0	8.0	7.4	3.5	7.2
GDP	**5.2**	**5.2**	**5.8**	**5.7**	**5.9**

Source: Department of Statistics, Malaysia

Private consumption spending remained strong, growing at 6.6% for the quarter (3Q: 6.8%). Major consumption indicators, such as credit card spending, imports of consumption goods and loans approved and disbursed for consumption credit purposes, confirmed this trend in private consumption expenditure. At the same time, the nationwide Year-End Sale carnival and promotions held in conjunction with the major festive celebrations and school holidays during the quarter spurred household spending. The main factor that contributed to the sustained growth in consumer spending was the steady increase in disposable income owing to firm commodity prices and the payment of year-end bonuses. Consumers' income prospects remained positive in view of stable labour market conditions, with retrenchments remaining low amid rising job vacancies. Consumers' optimistic outlook on job prospects and income expectations was reflected in the Consumer Sentiment Index (CSI), which rose to 110.9 points (3Q: 107.5 points), the highest level in 2006. Meanwhile, **public consumption** grew by 6.9% due mainly to higher expenditure for emoluments.

Gross fixed capital formation recorded a robust growth of 9.8% in the fourth quarter of 2006 (3Q: 3.5%). Investment activities by the public sector rose significantly as the Federal Government stepped up its disbursement of development expenditure. The spending was mainly channeled towards improving essential services including transportation, agriculture and rural development, public utilities, and provision of education as well as health services. At the same time, private sector capital spending remained strong, as evidenced by the upward trend in major indicators such as imports of capital goods and loans approved to businesses, especially to the manufacturing and construction sectors. Furthermore, business sentiments remained resilient, and the sustained high capacity utilisation rates in the manufacturing sector supported the expansion in private investment activities. Reflecting the positive business sentiment,

Consumer Confidence Improved, while Business Confidence Remained Resilient



Source: Malaysian Institute of Economic Research (MIER)

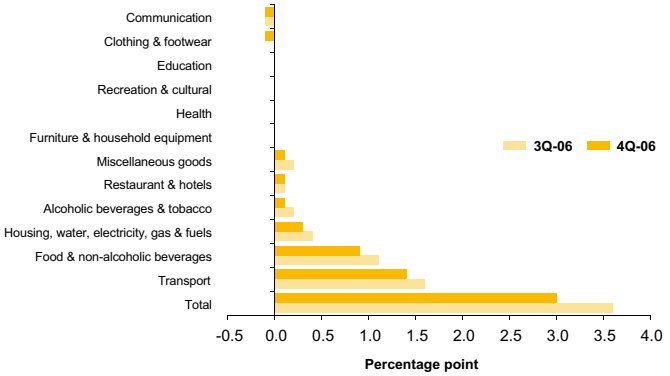
the Business Conditions Index (BCI) was sustained at 107.2 points (3Q: 107.8 points).

Inflation moderated in the fourth quarter

For the fourth quarter, headline inflation, as measured by the Consumer Price Index (CPI), moderated to 3% (3Q: 3.6%), in line with market and official expectations. The decline in inflation was broad-based with all the major categories of the CPI basket registering lower inflation rates, due mainly to supply factors. The decline in the inflation rate of the transport category reflected the lapse of the upward price adjustments of retail petroleum products which took place in 2005. The lapse of the October 2005 imposition of excise duties on items in the alcoholic beverages and tobacco category contributed to the slower rate of inflation for this category in the fourth quarter. Demand-induced inflation was relatively subdued despite sustained private consumption growth during the quarter. Competitive pressures continued to sustain the decline in the prices of clothing and footwear and communication charges. For the year as a whole, the headline inflation rate averaged at 3.6% (2005: 3%)

The rate of increase of raw material costs slowed in the fourth quarter, reflecting the moderating global oil prices. Consequently, producer price inflation slowed to 5.6% in the fourth quarter (3Q: 6.4%), as prices in the commodity-related category rose at a slower pace of 1.4% (3Q: 5%). Excluding commodities, the annual rate of increase in the PPI was relatively stable at 7% (3Q: 6.9%), supported mainly by the higher inflation of manufactured goods. For the year as a whole, producer price inflation moderated slightly to 6.7% from 6.8% in 2005.

Contribution to Consumer Price Inflation



Stable labour market conditions

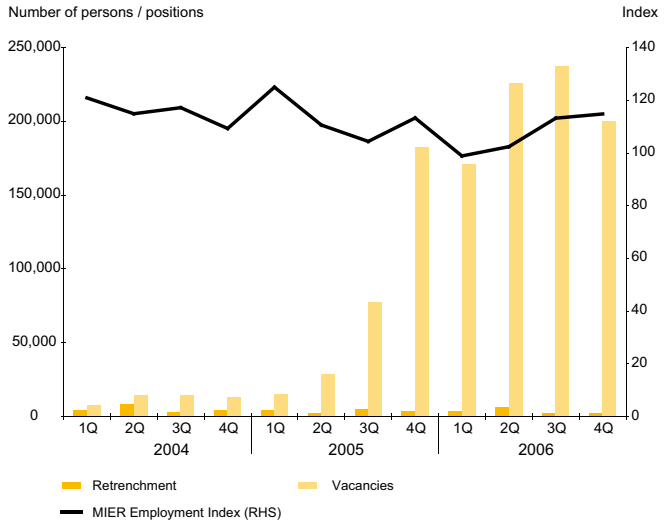
In the fourth quarter, the number of new job vacancies reported continued to be significant with job openings across all economic sectors. Although total retrenchments were higher than the previous quarter, they remain considerably lower than the peak recorded in the second quarter.

The number of new vacancies reported via the Electronic Labour Exchange (ELX) continued to be substantial, about 200,523 positions (3Q: 237,407 positions), with job openings found mainly in the manufacturing, agriculture and services sectors. The bulk of the positions advertised in the ELX were mainly lower skilled jobs such as elementary occupations (61%), which are more suitable for non-executives. One reason for this could be the Government requirement that employers post vacancies on the Exchange prior to submitting applications to hire foreign migrant workers. Nevertheless, total vacancies available in the economy is likely to be much higher than that reported by the ELX as employers also draw on the expertise and reach of private employment agencies and print media to fill available jobs. The positive employment outlook and the increased job opportunities in the market are also reflected in the improvement of the MIER

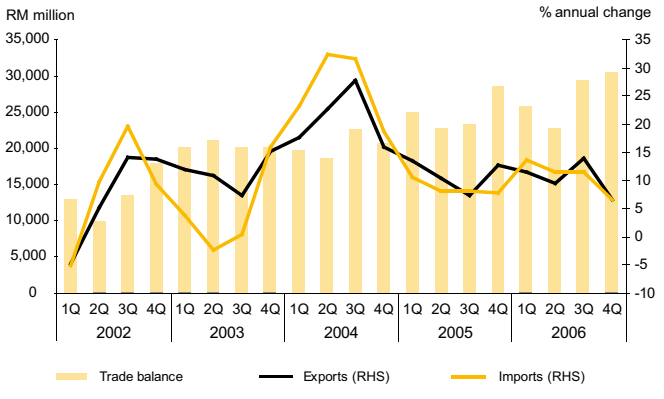
Employment Index to 114.8 points in the fourth quarter (3Q: 113.2 points).

Real labour productivity growth in the manufacturing sector moderated in the fourth quarter but continued to surpass real wage growth. Real sales value per employee was about the same as a year earlier (3Q: 1.1%), due to the weaker sales of manufactured products. During the same period, wage pressures continued to be subdued (-1.2%; 3Q: -1.8%).

Labour Market Conditions



Trade Balance



Continued expansion in both exports and imports

The **trade account** recorded a surplus of RM30.4 billion (3Q: RM29.4 billion) in the fourth quarter of 2006. Both gross exports and imports continued to expand by 6.6% (3Q: 13.9% and 11.5%, respectively).

Growth in **gross exports** was influenced by slower expansion in manufactured goods and decline in mineral exports. However, agricultural exports continued to remain strong.

The slower expansion in **manufacturing exports** (5.7%; 3Q: 14.2%) was due mainly to E&E exports (1.7%; 3Q: 10.3%) affected by the softer demand in particular, for computers and parts, which more than offset the higher shipment of telecommunication equipment. Exports of resource-based products such as chemicals, rubber, wood and metal related products continued to perform favourably. While chemical exports were supported by the strong demand from the regional countries, exports of rubber products were mainly driven by increased volume.

Agriculture exports strengthened further to increase by 22.8% (3Q: 19.7%) driven by the strong performance of the two largest agricultural commodities, namely palm oil and rubber. Growth in palm oil exports accelerated as a result of a significant increase in external demand (21.4%) and price (14.7%). The upward trend in external demand for crude palm oil is due to its increasing utilisation for both edible and non-edible

purposes, including as a healthier substitute for other edible oils that contain trans fatty acids and as feedstock to produce palm-based biodiesel. External markets where demand rose significantly during the quarter included the PR China, the European Union, India, and the United States. Concomitant with the increase in demand, price of crude palm oil rose to an average of RM1,672 per tonne (3Q: RM1,594 per tonne). Meanwhile, the growth in rubber exports (12.7%) was due mainly to higher prices (+11.1% to 657 sen per kilogramme).

Mineral exports rose by 2.5% in the fourth quarter led mainly by higher proceeds from liquefied natural gas (LNG) which rose by 10.7%. The growth in LNG receipts was driven by the increase in export prices. Meanwhile, exports of crude oil declined due to lower shipment during the quarter, while prices remained stable at USD63.50 per barrel compared to the corresponding quarter of 2005.

Exports to the European Union (EU) expanded by 20.5% and consisted mainly of E&E products, palm oil, crude rubber, optical and scientific equipment, as well as wood products. The United Kingdom, Netherlands and Germany were the major export destinations. Export growth to the US moderated to 1%, reflecting mainly slower growth in exports of computers and computer related parts. Of significance, exports to West Asia increased by 33.1% (3Q: 20.4%), spurred by demand for electrical machinery, electrical apparatus as well as iron and steel products.

Malaysia's exports to the regional countries (excluding Japan) expanded by 3.1%, driven by demand from PR China, Indonesia, Thailand, and South Korea. Demand from PR China was for E&E products and resource-based products, such as petroleum-related products, chemical products, rubber products and manufactures of metal. Demand for commodities, such as crude palm oil and rubber also increased. Meanwhile, Korea continued to source LNG, crude petroleum and chemicals from Malaysia. Exports to India increased by 30.1%, supported by strong demand for crude oil, palm oil, electric apparatus, office machines as well as iron and steel products.

Meanwhile, Malaysia also sourced components from the regional countries, particularly Thailand, PR China and South Korea. Imports from the regional countries expanded by 10.7%, consisting mainly of E&E products, iron and steel products, and chemicals and chemical products. Imports from the EU countries also strengthened and consisted mainly of E&E products, aircraft as well as optical and scientific equipment.

During the quarter, **gross imports** increased, though at a more moderate pace of 6.6%, due mainly to slower growth in **intermediate imports**, in tandem with lower external demand for E&E products.

Trade Account

	2005		2006		
	4Q	Year	3Q	4Q	Year
	Annual change (%)				
Gross Exports	**12.8**	**10.9**	**13.9**	**6.6**	**10.3**
Manufacturing	*13.0*	*10.0*	*14.2*	*5.7*	*10.1*
Agriculture	*-0.3*	*0.6*	*19.7*	*22.8*	*12.7*
Minerals	*21.1*	*26.4*	*3.2*	*2.5*	*9.2*
Gross Imports	**7.8**	**8.6**	**11.5**	**6.6**	**10.7**
Capital goods	*2.0*	*9.5*	*-4.6*	*4.6*	*7.6*
Intermediate goods	*6.2*	*7.1*	*12.0*	*6.7*	*8.7*
Consumption goods	*6.6*	*7.5*	*14.7*	*12.1*	*13.4*
Trade balance (RM bil)	**28.6**	**99.8**	**29.4**	**30.4**	**108.5**

Source: Department of Statistics, Malaysia

Malaysia: Direction of Exports

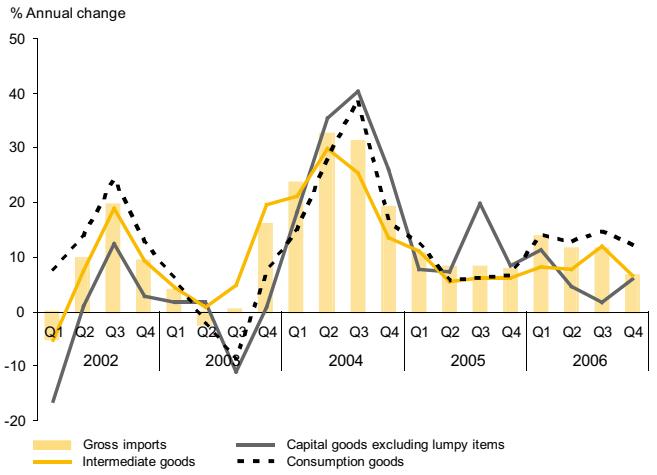
	2005		2006			2005		2006			2005		2006		
	4Q	Year	3Q	4Q	Year	4Q	Year	3Q	4Q	Year	4Q	Year	3Q	4Q	Year
	RM billion					Share of total exports (%)					Annual change (%)				
United States	**27.5**	**105.0**	**30.1**	**27.8**	**110.6**	**19.3**	**19.7**	**19.2**	**18.3**	**18.8**	**18.8**	**16.4**	**4.2**	**1.0**	**5.3**
European Union (EU)	**17.5**	**62.6**	**20.1**	**21.1**	**74.9**	**12.3**	**11.7**	**12.8**	**13.9**	**12.7**	**11.2**	**3.6**	**29.9**	**20.5**	**19.7**
Selected ASEAN countries[1]	**36.7**	**137.8**	**39.9**	**37.5**	**152.5**	**25.7**	**25.8**	**25.4**	**24.6**	**25.9**	**14.9**	**15.4**	**14.5**	**2.2**	**10.6**
North East Asia	**27.0**	**99.2**	**29.5**	**28.2**	**109.1**	**18.9**	**18.6**	**18.8**	**18.5**	**18.5**	**11.0**	**5.5**	**20.1**	**4.4**	**10.0**
People's Republic of China	*10.5*	*35.2*	*12.7*	*11.7*	*42.7*	*7.3*	*6.6*	*8.1*	*7.7*	*7.2*	*26.0*	*9.1*	*48.9*	*11.9*	*21.1*
Hong Kong China	*7.8*	*31.2*	*7.5*	*6.8*	*29.1*	*5.5*	*5.8*	*4.8*	*4.5*	*4.9*	*6.5*	*8.6*	*-10.8*	*-12.6*	*-6.6*
Chinese Taipei	*4.0*	*14.8*	*4.6*	*4.1*	*16.0*	*2.8*	*2.8*	*2.9*	*2.7*	*2.7*	*-2.6*	*-7.8*	*15.8*	*2.8*	*8.3*
Korea	*4.7*	*17.9*	*4.8*	*5.5*	*21.3*	*3.3*	*3.4*	*3.1*	*3.6*	*3.6*	*3.0*	*5.9*	*28.1*	*17.3*	*18.6*
India	**4.2**	**15.0**	**5.3**	**5.4**	**18.8**	**2.9**	**2.8**	**3.4**	**3.6**	**3.2**	**31.9**	**30.7**	**36.2**	**30.1**	**25.5**
Total exports	**142.6**	**533.8**	**157.1**	**152.0**	**588.9**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**12.8**	**10.9**	**13.9**	**6.6**	**10.3**

[1] Singapore, Thailand, Indonesia, Philippines, Brunei Darussalam and Vietnam

Source: Department of Statistics, Malaysia

Intermediate imports, which consist mainly of primary and processed industrial supplies such as metal and metal products, electronics as well as parts of telecommunication products, expanded by 6.7%. Imports for the domestic market, namely primary and processed materials used by the food and beverage industry also continued to expand. Imports of parts and accessories of transport equipment, however, declined concomitant with lower domestic demand for motor vehicles.

Import Growth



Imports of **capital goods** expanded by 4.6% (3Q: -4.6%) to RM16.7 billion during the quarter. Strong demand for commodity exports and expansion in intra-regional travel led to the delivery of more aircraft and ships. Imports of construction and mining equipment strengthened, spurred by continued exploration and development activities in the oil and gas sector. Imports of telecommunication equipment also increased during the quarter, reflecting the upgrading of communications infrastructure.

Consonant with strong private consumption, imports of **consumption goods** increased by 12.1% (3Q: 14.7%) to RM7.4 billion. These imports were semi-durable

and non-durable items such as medicines, records, clothing and footwear as well as recreational and sports equipment. Household consumption items, such as primary and processed food and beverages also increased as festivities stimulated demand.

Higher inflows of FDI and portfolio investment

On a cash basis, gross inflows of **foreign direct investment (FDI)** increased to RM18.1 billion in the fourth quarter of 2006 (3Q: RM12.4 billion), due mainly to larger inflows of equity capital and sustained inflows of inter-company loans. The significantly larger inflows of equity capital reflected mainly inflows of funds for acquisition of a Malaysian company in the manufacturing sector as well as investment in the Islamic financial services. There were also inflows of funds for investment in the petroleum-related, textiles and chemical industries. Meanwhile, the bulk of the inter-company loans was in the form of short-term loans extended by foreign companies to their subsidiaries in Malaysia, particularly in the services and oil and gas sectors. After adjustments for gross outflows due mainly to repayments of inter-company loans, net FDI increased to RM12 billion (3Q: RM5.5 billion). The FDI data on cash basis does not include retained earnings and investment in the form of imported machinery and equipment.

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

	2005		2006		
	4Q	Year	3Q	4Q	Year
	Annual change (%)				
CAPITAL GOODS	**2.0**	**9.5**	**-4.6**	**4.6**	**7.6**
Capital goods (except transport equipment)	7.5	11.5	0.8	5.1	5.6
Transport equipment	-27.0	-4.5	-39.9	-0.1	23.5
INTERMEDIATE GOODS	**6.2**	**7.1**	**12.0**	**6.7**	**8.7**
Food and beverages, mainly for industry	6.3	-4.9	24.8	18.1	24.9
Industrial supplies, n.e.s.	1.3	7.4	22.8	19.0	11.0
Fuel and lubricants	33.0	42.6	45.6	-2.9	25.0
Parts and accessories of capital goods (except transport equipment)	4.8	1.9	1.6	3.1	5.1
Parts and accessories of transport equipment	12.9	33.4	-10.2	-21.7	-8.5
CONSUMPTION GOODS	**6.6**	**7.5**	**14.7**	**12.1**	**13.4**
Food and beverages, mainly for household consumption	-0.7	4.1	4.5	5.5	4.7
Transport equipment, non-industrial	17.8	-3.4	-35.0	45.8	9.4
Consumer goods, n.e.s.	11.3	10.0	22.4	15.1	18.8
Durables	*23.8*	*16.3*	*4.4*	*14.8*	*10.1*
Semi-durables	*9.8*	*4.7*	*44.4*	*15.0*	*34.7*
Non-durables	*6.4*	*10.8*	*15.8*	*8.4*	*12.4*
DUAL USE GOODS	**14.2**	**24.2**	**14.8**	**-6.8**	**7.6**
OTHERS	**5.0**	**3.3**	**-25.1**	**-3.5**	**-2.8**
RETAINED IMPORTS	**5.8**	**7.8**	**9.0**	**6.2**	**8.6**
RE-EXPORTS	**52.0**	**26.1**	**63.3**	**12.0**	**50.4**
GROSS IMPORTS	**7.8**	**8.6**	**11.5**	**6.6**	**10.7**

Source: Department of Statistics, Malaysia

Overseas investment by Malaysian companies increased to RM28.7 billion (3Q: -RM23.2 billion) reflecting mainly a marked increase in the short-term loan extensions by non-resident controlled companies in the services and manufacturing sectors to their related companies abroad arising from their centralised treasury operations. These outflows were offset largely by inflows arising from repayment of short-term inter-company loans during the quarter. After adjusting mainly for these inflows, overseas investment recorded a smaller net outflow of RM1.4 billion (3Q: -RM2.1 billion). The bulk of the net outflows for overseas investment were in the form of equity capital, and effected mainly by companies in the services, manufacturing and oil and gas sectors. In the services sector, overseas investment were channeled mainly into the finance, insurance, real estate and business services sub-sectors. Meanwhile, overseas investments by the manufacturing sector were led by companies in the E&E and food sub-sectors.

Portfolio investment turned around to register a net inflow of RM7.8 billion (3Q: -RM2.2 billion) in the fourth quarter. The positive economic prospects following the announcements of the rolling out of 9MP projects, the mergers and acquisitions activities in the plantation sector and the development of the Iskandar Development Region, as well as the stronger corporate earnings announcements attracted inflows of portfolio funds for investment, particularly in the equity market.

External debt declined further

Malaysia's total external debt improved considerably to RM179.5 billion or USD50.3 billion as at end-2006 (3Q: RM199.6 billion or USD53.6 billion), equivalent to 34.1% of GNP. The **medium and long-term external debt** was lower at RM138 billion (3Q: RM148.9 billion), reflecting mainly the net repayment of external debt by the public sector, and partly, the exchange revaluation gain following the appreciation of the ringgit against major currencies, in particular the US dollar. The NFPEs recorded a larger net repayment of external loans due to the maturity of a USD-denominated bond and some scheduled principal loan repayments, particularly by companies in the oil and gas and utilities sectors. Meanwhile, the net loan repayment by the Federal Government mainly reflected the maturity of two syndicated loans amounting to RM2.9 billion. The private sector continued to record a net drawdown of external loans of RM2.1 billion (3Q: RM1.1 billion), mainly by companies in the financial services and construction sectors.

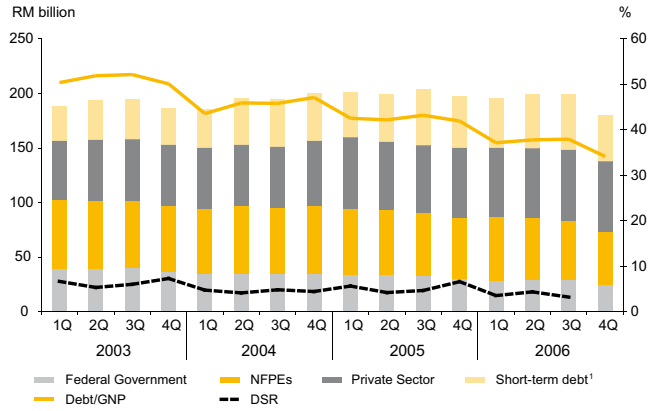
External Debt Outstanding

	2005	2006	
	4Q	3Q	4Q [p]
	RM billion		
Medium- and Long-term debt	150.7	148.9	138.0
Public sector	86.2	83.7	73.2
Private sector	64.5	65.1	64.8
Short-term debt[1]	47.0	50.8	41.5
Total external debt	197.7	199.6	179.5
- USD billion equivalent	51.8	53.6	50.3

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

Source: Ministry of Finance, Malaysia and Bank Negara Malaysia

External Debt Outstanding



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

The total **short-term external debt** declined to RM41.5 billion or USD11.6 billion, reflecting mainly lower short-term borrowings by the banking sector. As at end-2006, the short-term debt accounted for only 23.1% of total external debt and was 14.3% of the net international reserves.

International reserves

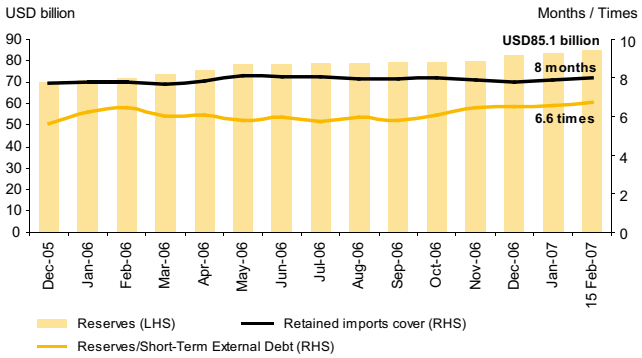
The international reserves of Bank Negara Malaysia amounted to RM290.4 billion or equivalent to USD82.5 billion as at 31 December 2006. The reserves level has taken into account the quarterly revaluation

loss, following the strengthening of ringgit against the major currencies. The reserves amounted to RM299.8 billion or equivalent to USD85.1 billion as at 15 February 2007. The reserves position is sufficient to finance 8 months of retained imports and is 6.6 times the short-term debt.

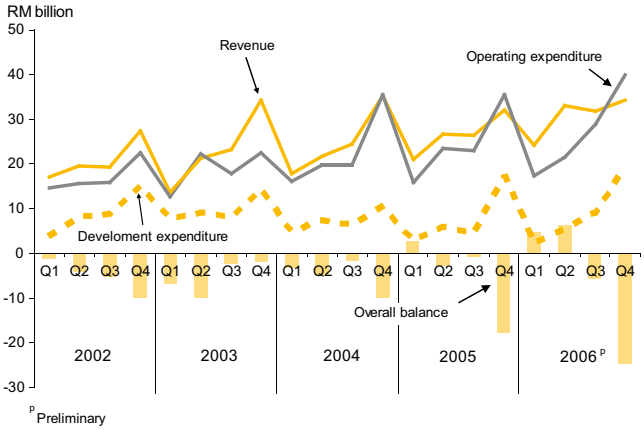
Larger fiscal deficit

The Federal Government's total expenditure was higher in the fourth quarter resulting in an overall fiscal deficit of 3.5% of GDP for the year as a whole. In particular, higher operating expenditure was recorded for the payment of emoluments due to the payment of bonuses in October and December. Meanwhile, revenue remained favourable on account of higher collection from oil related revenue. The fiscal deficit was funded largely from a drawdown of the realisable assets of the Government and domestic borrowings. As at end-2006, total outstanding debt of the Federal Government was lower at RM242.1 billion or 44.3% of GDP, reflecting mainly the maturity of two external syndicated loans in December.

Net International Reserves (as at end period)



Federal Government Finance



P Preliminary

Federal Government Finance[P]

	2005	2006[P]	
	4Q	3Q	4Q
	RM billion		
Revenue	32.2	31.9	34.4
% growth	*-8.7*	*20.8*	*6.9*
Operating expenditure	35.5	28.8	40.0
% growth	*-0.2*	*25.2*	*12.8*
Current account	**-3.3**	**3.1**	**-5.6**
% of GDP	***-2.5***	***2.2***	***-4.0***
Gross development expenditure	17.5	9.1	19.4
% growth	*66.5*	*108.1*	*11.0*
Overall balance	**-17.9**	**-5.8**	**-24.6**
% of GDP	***-13.7***	***-4.1***	***-17.5***
Memo item:			
Total gross expenditure	52.9	37.8	59.4
% growth	*15.0*	*38.4*	*12.2*
Total Federal Government debt			
(as at end-period)	228.7	245.8	242.1
% of GDP	*46.2*	*45.2*	*44.3*
Domestic debt	198.7	216.9	217.2
% of GDP	*40.1*	*39.9*	*39.8*
External debt	30.0	28.9	24.9
% of GDP	*6.1*	*5.3*	*4.6*

[P] Preliminary

MONETARY AND FINANCIAL DEVELOPMENTS

Lending rates remained stable while real FD rates for all maturities turned positive

With inflation trending downwards amid a sustained economic growth outlook, the Overnight Policy Rate (OPR) was left unchanged at 3.50% throughout the fourth quarter.

During the period 2 October – 29 December, the average overnight interbank rate remained stable, moving within a range of 3.48% – 3.53%. Interbank rates of other maturities also remained relatively stable.

In terms of retail lending rates, the average base lending rate (BLR) of commercial banks (CBs) remained unchanged at 6.72%. At the same time, the average lending rate (ALR) declined marginally to 6.57% as at end-December from the third quarter level of 6.63%. The average quoted fixed deposit (FD) rates of CBs for the 1-month and 12-month maturities ranged between 3.11% and 3.73% respectively (3Q: 3.13% to 3.77%). Of significance, the real FD rates for all maturities turned positive in October following lower inflation.

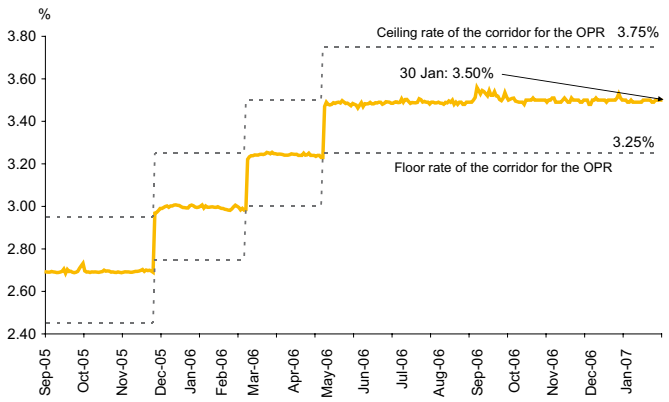
Monetary aggregates grew faster

M1, or narrow money expanded at a higher annual rate of 13.8% in the fourth quarter (3Q: 11.5%), reflecting both the higher demand deposits placed by the business enterprises and the higher amount of currency held by the private sector. M3, or broad money, also increased at a higher rate of 12.3% during the quarter (3Q: 7.9%).

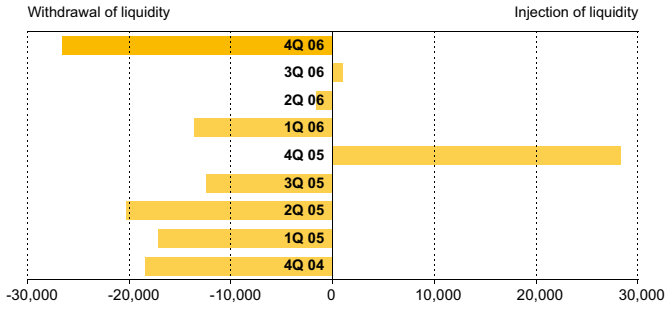
Interest Rates

	2005	2006			
	4Q	1Q	2Q	3Q	4Q
	At end-period (%)				
Overnight Policy Rate (OPR)	3.00	3.25	3.50	3.50	3.50
Interbank rates					
Overnight	3.00	3.25	3.51	3.51	3.50
1-month	3.12	3.25	3.78	3.68	3.58
Base lending rates (BLR)					
Commercial banks	6.20	6.47	6.72	6.72	6.72
Average lending rates (ALR)					
Commercial banks	6.12	6.29	6.55	6.63	6.57
Fixed deposit rates					
Commercial banks					
3-month	3.02	3.06	3.18	3.21	3.19
12-month	3.70	3.70	3.77	3.77	3.73

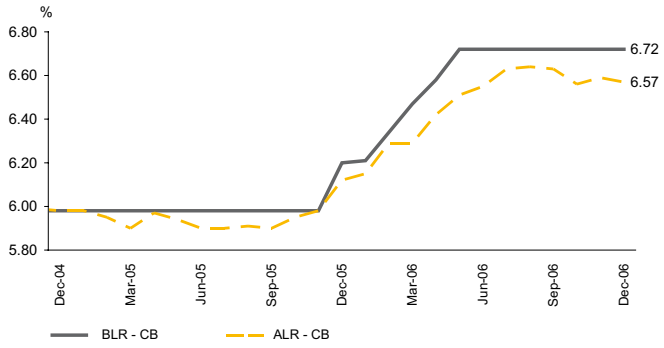
Daily Weighted Average Overnight Interbank Rate



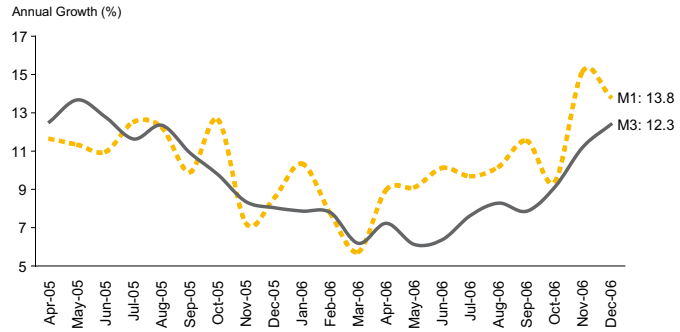
Bank Negara Malaysia Liquidity Operations
(During the quarter, RM million)



Lending Rates of Commercial Banks
(Average for the period)



Monetary Aggregates



Determinants of Broad Money, M3

	Change during the period				
	2005		2006		
	4Q	Year	3Q	4Q	Year
	RM billion				
M3	10.8	49.7	14.3	41.5	82.4
Net claims on Government	12.7	-5.4	-2.2	19.9	9.2
Claims on private sector	14.0	44.4	6.7	7.9	34.7
Loans	*8.5*	*44.8*	*9.2*	*8.2*	*36.8*
Securities	*5.6*	*-0.4*	*-2.5*	*-0.3*	*-2.1*
Net external operations[1]	-23.6	17.3	11.9	22.7	59.8
BNM	*-34.7*	*29.0*	*2.0*	*5.2*	*32.2*
Banking system	*11.1*	*-11.7*	*9.9*	*17.4*	*27.6*
Other influences	7.6	-6.7	-2.1	-9.0	-21.4

[1] Pre-revaluation

During the quarter, the expansion in M3 was driven mainly by the increase in net foreign assets arising from higher inflows from the external sector in the form of export proceeds, net foreign direct investments and portfolio investments. In contrast with the previous quarters, net claims on the Government exerted an expansionary impact on M3 as the Government funded higher expenditure through the drawdown of deposits placed with Bank Negara Malaysia. Claims on the private sector expanded on account of higher loans outstanding. These were, however, slightly offset by lower holdings of private debt securities by the banking institutions.

Slower private sector financing growth in the fourth quarter

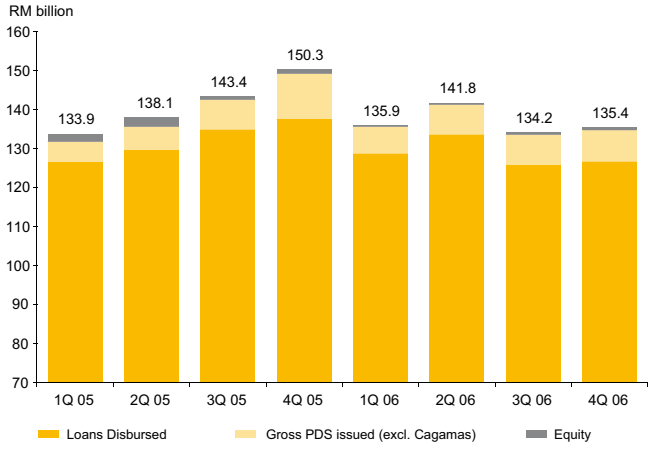
In the fourth quarter, gross financing of the private sector through the banking system and capital market amounted to RM135.4 billion, (3Q: RM134.2 billion). Compared with the preceding quarter, however, loan disbursements by the banking system and funds raised through the capital market was higher. On a net basis, banking system loans and PDS outstanding expanded at a combined annual rate of 6.2% at end-December.

Financing of the Private Sector through Banking System and Capital Market

	During the period (RM billion)				Annual growth (%)		
	2005	4Q 05	3Q 06	4Q 06[p]	2005	3Q 06	4Q 06[p]
Gross total financing	**565.6**	**150.3**	**134.2**	**135.4**	**8.7**	**-6.4**	**-9.9**
Loans disbursed *	528.6	137.5	125.8	126.7	8.3	-6.7	-7.9
Gross PDS (excl. Cagamas)	30.8	11.7	7.9	8.1	20.3	3.4	-31.0
Equity	6.3	1.0	0.5	0.6	-2.5	-39.2	-39.4
Outstanding total financing (A)+(B)	**62.2**	**17.4**	**11.6**	**6.3**	**9.3**	**7.9**	**6.2**
Banking system	46.3	13.5	10.4	9.5	8.5	8.8	7.9
Loans outstanding (A)[p]	44.2	10.1	9.6	4.0	8.6	7.5	6.3
Holding of PDS	2.1	3.5	0.8	5.5	6.3	30.8	33.4
PDS outstanding (B)	18.0	7.3	2.0	2.3	11.4	9.2	6.0
Memorandum item							
Gross PDS (incl. Cagamas)	38.2	15.2	9.2	8.3	5.2	-5.2	-45.3

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

Gross Private Sector Financing through Banking System and Capital Market



On an annual basis, overall loan disbursements were lower mainly on account of the lower loans disbursed to the business sector. During the quarter, loan disbursements to businesses declined by 8.5% (3Q: 6.3%), with the moderation mainly accounted for by lower loans disbursed to the manufacturing; wholesale and retail trade, restaurants and hotels sector. Nevertheless, business loan applications and approvals registered strong positive growth rates in the fourth quarter in line with the strong performance of the construction sector and the domestic construction-related manufacturing industries. As a result, new loan applications and approvals rose by 6.5% and 4.2% respectively (3Q: -5.5% and -13.4% respectively). In the household sector, the major loan indicators were lower on an annual basis primarily on account of lower financing channelled for the purchase of passenger cars, and to a lesser extent, residential property.

Total loans outstanding expanded by 6.3% on an annual basis at the end of the fourth quarter (end-3Q 2006: 7.5%), with loans outstanding to businesses and households increasing at annual rates of 4.2% and 9.4% respectively (end-3Q 2006: 3.3% and 11.4% respectively).

Loan Indicators

	During the period (RM billion)				Annual Growth %			
	2005	4Q 05	3Q 06	4Q 06[P]	2005	4Q 05	3Q 06	4Q 06[P]
Total								
Loan applications[n]	305.4	72.1	79.3	76.8	11.7	6.4	-5.5	6.5
Loan approvals[n]	192.2	47.7	47.1	49.7	10.7	10.4	-13.4	4.2
Loan disbursements[n]	528.6	137.5	125.8	126.7	8.3	5.2	-6.7	-7.9
Loan repayments[n]	488.5	128.5	116.2	121.8	5.8	6.5	-4.4	-5.2
Change in loan outstanding[1]	44.2	10.1	9.6	4.0	8.6	8.6	7.5	6.3
Of which:								
Business enterprises[2]								
Loan applications[n]	153.1	35.0	41.2	40.8	6.8	-2.8	-2.4	16.6
Loan approvals[n]	88.3	22.7	22.8	28.0	9.4	12.2	-12.5	23.3
Loan disbursements[n]	375.1	97.8	88.9	89.5	7.0	3.2	-6.3	-8.5
Loan repayments[n]	367.1	97.1	84.8	87.9	5.3	6.3	-6.7	-9.3
Change in loan outstanding[1]	6.5	-0.9	3.1	1.1	3.0	3.0	3.3	4.2
SMEs[3]								
Loan applications[n]	59.4	12.6	18.8	19.4	10.4	-6.9	n.a.	n.a.
Loan approvals[n]	34.9	7.9	10.2	11.8	11.5	-6.3	n.a.	n.a.
Loan disbursements[n]	110.6	29.2	33.6	32.9	9.3	4.3	n.a.	n.a.
Change in loan outstanding[1]	7.7	1.5	0.9	-1.0	8.7	8.7	n.a.	n.a.
Large corporations[3]								
Loan applications[n]	93.6	22.4	22.4	21.4	4.7	-0.4	n.a.	n.a.
Loan approvals[n]	53.4	14.9	12.6	16.3	8.0	25.3	n.a.	n.a.
Loan disbursements[n]	264.5	68.6	55.3	56.7	6.0	2.7	n.a.	n.a.
Change in loan outstanding[1]	-1.1	-2.3	2.2	2.1	-0.9	-0.9	n.a.	n.a.
Households								
Loan applications[n]	152.3	37.1	38.1	35.9	17.2	16.8	-8.7	-3.2
Loan approvals[n]	103.9	25.0	24.3	21.7	11.9	8.7	-14.2	-13.2
Loan disbursements[n]	153.7	39.9	36.9	37.2	11.7	11.0	-7.7	-6.9
Loan repayments[n]	121.5	31.6	31.4	33.9	7.6	7.0	2.5	7.4
Change in loan outstanding[1]	40.0	10.7	7.3	5.8	15.1	15.1	11.4	9.4

[1] The annual growth is for end-period.

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

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

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

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

Source: Bank Negara Malaysia.

Loans by Sector

	Loans disbursed					Loans out-standing
	During the period				Share of total	Share of total
	2005	4Q 05	3Q 06[p]	4Q 06[p3]		
	RM billion				%	
Business enterprises [1]	375.1	97.8	88.9	89.5	70.7	39.6
Large corporations [2]	*264.5*	*68.6*	*55.3*	*56.7*	*44.8*	*22.4*
SMEs [2]	*110.6*	*29.2*	*33.6*	*32.9*	*26.0*	*17.3*
Households	153.7	39.9	36.9	37.1	29.3	56.5
Selected sectors						
Agriculture, hunting, forestry and fishing	13.8	3.6	3.5	3.3	2.6	2.2
Mining and quarrying	1.6	0.4	0.5	0.3	0.2	0.2
Manufacturing	126.7	31.5	30.3	30.4	24.0	11.2
Construction	30.4	7.7	7.6	7.9	6.2	5.3
Real estates	9.0	2.6	2.2	2.0	1.6	2.9
Electricity, gas and water supply	7.1	1.9	0.4	0.4	0.3	0.8
Wholesale, retail, restaurants and hotels	97.2	25.2	22.1	21.2	16.7	8.9
Transport, storage and communication	9.8	2.4	2.3	2.8	2.2	1.9
Finance, insurance and business services	35.7	9.8	10.6	9.6	7.6	5.8
Consumption credit	100.8	26.5	25.2	24.7	19.5	23.9
Of which:						
Credit cards	*42.7*	*11.7*	*12.7*	*13.6*	*10.7*	*3.4*
Purchase of passenger cars	*39.2*	*10.0*	*8.4*	*6.8*	*5.4*	*16.6*
Total	**528.6**	**137.5**	**125.8**	**126.7**	**...**	**...**

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

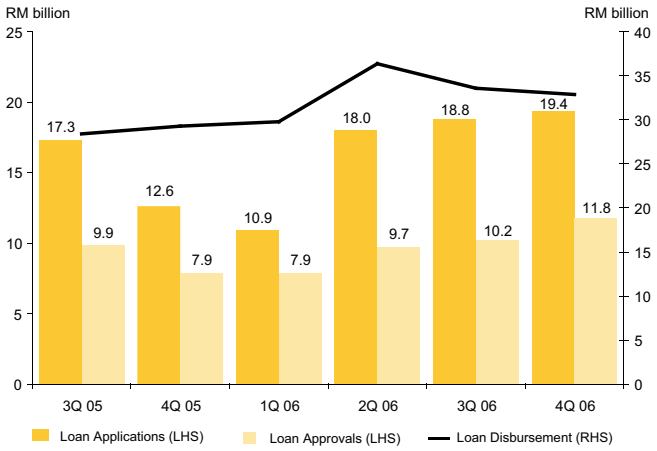
[2] From 1Q 2006, loan indicators for SMEs and large corporations are not comparable on an annual basis as beginning March 2006, financial institutions have begun adopting the Standard SME Definitions as approved by the National SME Development Council, resulting in some reclassification between SMEs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

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

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

Source: Bank Negara Malaysia

Bank Lending to SMEs



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

Higher financing activity in the capital market

Fund raising activity in the capital market increased significantly during the quarter with total net funds raised by both the public and private sectors amounting to RM7.5 billion.

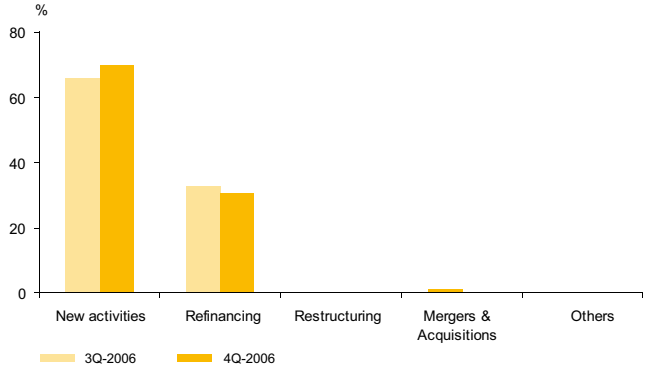
The bulk of the funds were raised by the public sector. Gross funds amounting to RM11.5 billion were raised from four issuances of Government securities, including one new issuance of 3-year Malaysian Government Securities (MGS), one new issuance of 10-year Government Investment Issues (GII) and a new 5-year MGS together with a RM500 million Callable MGS. On a net basis, funds raised by the public sector were higher at RM7.3 billion during the quarter (3Q: RM3.6 billion). The inaugural issuance of Callable MGS was part of the new measures introduced to further develop the MGS market. The instrument would provide an option for the Government to redeem the bond ahead of its maturity for better cashflow management. In addition, the instrument would also benefit the private sector as it would serve as a benchmark for private sector issuers to price their own callable private debt securities.

Funds Raised in the Capital Market

	2005		2006		
	4Q	Year	3Q	4Q	Year
	RM million				
By Public Sector					
Government Securities, *gross*	6,500	26,830	9,324	6,500	26,830
Less Redemptions	4,850	12,850	8,200	2,850	12,850
Less Government holdings	-	-	-	-	-
Equals Net Federal receipts	1,650	13,980	1,124	3,650	13,980
Khazanah Bonds, *net*	-	(630)	-	1,070	(630)
Govt. Investment Issues, *net*	(1,000)	9,500	3,000	3,000	9,500
Merdeka Savings Bond, *net*	397	(1,931)	(495)	(433)	(1,931)
Net Funds Raised	1,047	20,919	3,629	7,287	20,919
By Private Sector					
Shares	1,043	1,916	518	632	1,916
Debt securities	15,161	38,887	9,233	8,297	38,887
Private Debt Securities (PDS)	13,801	31,737	7,933	8,097	31,737
Cagamas	1,360	7,150	1,300	200	7,150
Less Redemptions	4,701	31,519	9,590	8,747	31,519
Net Issues	10,461	7,368	(356)	(451)	7,368
Net issues (excluding Cagamas)	9,851	11,120	2,404	2,409	11,120
Net Funds Raised	11,504	9,284	161	182	9,284
Total Net Funds Raised	12,552	30,203	3,790	7,469	30,203
Short-term Papers and Notes, *net* [1]	456	2,563	(577)	653	2,563
Total	13,008	32,766	3,213	8,122	32,766

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

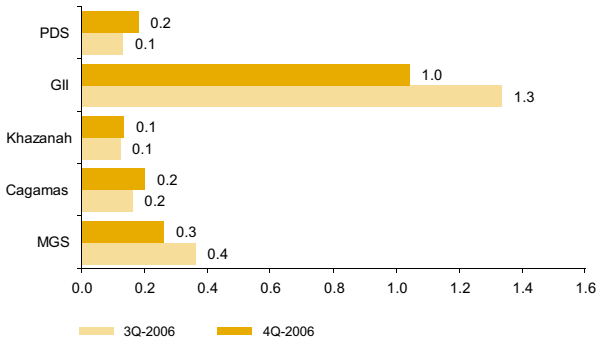
Private Debt Securities Issued by Purpose (% of total)



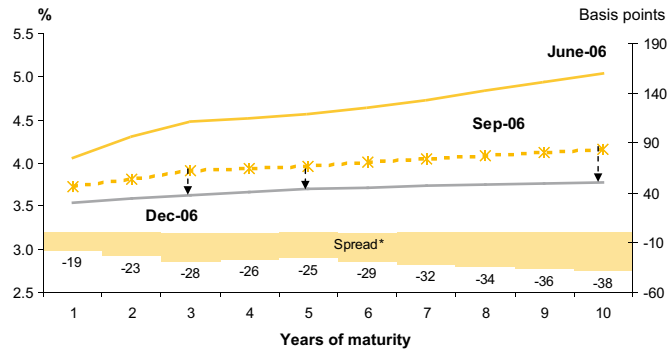
In the private sector, gross funds raised from the private debt securities (PDS) market, which amounted to RM8.3 billion, were lower compared to the previous quarter. Excluding Cagamas, the gross funds raised remained substantial, amounting to RM8.1 billion, and were mainly raised through the issuance of medium-term notes, which accounted for 58% of the total PDS issued. On a net basis, the funds raised through the PDS market, excluding Cagamas, amounted to RM2.4 billion during the quarter.

Funds raised through the equity market increased during the fourth quarter, amounting to RM632 million. Most of the funds were raised through 8 initial public offerings (IPOs) totaling about RM464 million. During the quarter, there were nine new listings on Bursa Malaysia, five on the Main Board, one on the Second Board and three on the MESDAQ Market.

Liquidity Ratio: Turnover / Outstanding

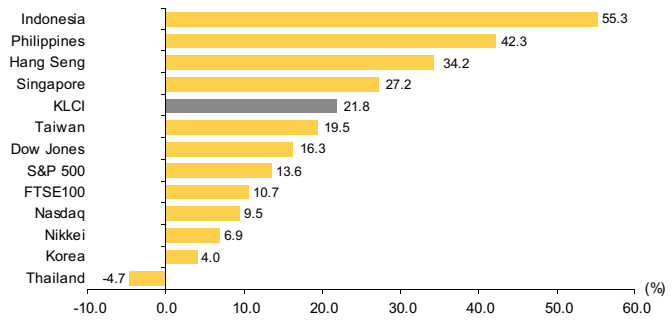


Trend in MGS Yield



* Spread (RHS) : Yield Dec-06 - Yield Sep-06

Performance of Selected Global and Regional Markets in 2006



Sustained secondary trading in the bond market

In the secondary market, total trading was sustained at RM105.1 billion in the fourth quarter (3Q: RM114.9 billion). Government Securities (MGS and GII) accounted for the bulk of total trade (62%), followed by private debt securities (32% of total trade). In terms of liquidity, the GII was the most liquid paper, registering a liquidity ratio of 1.04.

The MGS benchmark yield curve shifted downwards between 18 – 50 basis points over all tenures during the fourth quarter of 2006. The decline was mainly due to the market's expectation that the OPR will remain unchanged following a more benign inflation outlook. In addition, the strengthening of the ringgit also influenced buying momentum in the market which contributed to the downward shift in the yield curve. The quarterly yield spreads for the 3-year, 5-year and 10-year MGS declined by 28, 25 and 38 basis points respectively.

Strongest performance of the KLCI for the year

The KLCI registered its strongest performance for the year in the fourth quarter, in tandem with regional and global equity markets. The moderating trend in inflation and the good corporate earnings boosted the overall

Bursa Malaysia: Turnover of Corporate Securities

	2005				2006					
	4Q		Year		3Q		4Q		Year	
	million units	RM million	million units	RM million	million units	RM million	million units	RM million	million units	RM million
Turnover	18,541	35,264	102,338	177,321	37,040	49,741	57,015	78,257	197,819	127,998
of which:										
Main Board	13,788	32,391	73,816	157,445	22,422	40,720	36,338	66,458	121,666	107,178
of which										
Consumer Products	647	1,863	3,694	10,197	660	2,200	977	2,665	4,765	4,866
Industrial Products	1,633	2,020	12,150	14,143	3,410	3,787	4,474	5,395	16,232	9,182
Construction	694	1,067	4,141	7,116	1,596	2,626	2,787	5,262	11,107	7,888
Trading/Services	3,321	12,417	16,008	59,241	5,958	15,148	10,465	26,467	31,469	41,615
Finance	2,262	8,796	10,108	36,743	2,475	7,291	3,689	12,719	12,092	20,010
Properties	1,392	1,236	10,649	11,572	4,084	2,331	5,742	3,681	21,022	6,013
Plantations	539	2,762	2,144	9,147	1,078	4,848	1,004	5,516	3,384	10,364
Mining	0	1	0	10	1	17	33	68	34	85
Second Board	1,708	1,175	15,161	12,289	3,853	2,758	5,432	4,023	21,914	6,782
Mesdaq	2,948	1,598	12,616	6,678	10,352	6,085	10,735	4,981	48,712	11,066

Source: Bursa Malaysia

Bursa Malaysia: Selected Market Indicators

	As at end		
	2005	2006	
	4Q	3Q	4Q
Price Indices			
Composite	899.8	967.6	1,096.2
FBM30[1]	5,882.5	6,260.4	7,059.9
FBMEMAS[2]	5,737.5	6,270.7	7,169.6
Second Board	80.4	83.2	92.0
Mesdaq	87.1	108.1	119.9
Average daily turnover			
Volume (million units)	303.9	573.9	934.7
Value (RM million)	578.1	782.0	1,282.9
Market capitalisation (RM billion)	695.3	745.5	848.7
No. of companies listed	1,021	1,027	1,027

[1] FBM30 stands for FTSE Bursa Malaysia 30 Index
[2] FBMEMAS stands for FTSE Bursa Malaysia Emas Index

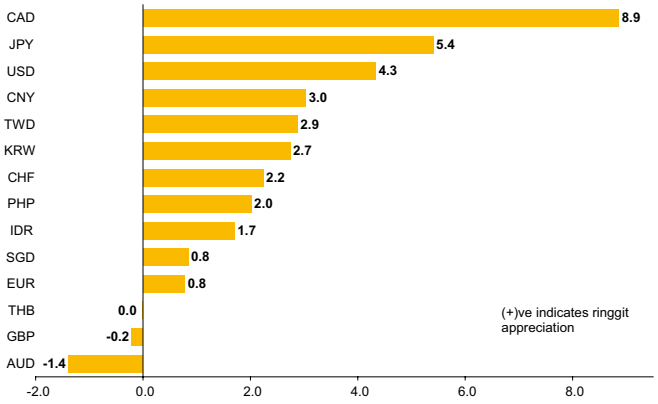
Source: Bursa Malaysia

performance of the KLCI. The plantation and construction sectors gained significantly, due to developments on mergers and acquisitions and announcements identifying high-impact Ninth Malaysia Plan projects. Participation from non-resident investors in the equity market was strong during this period.

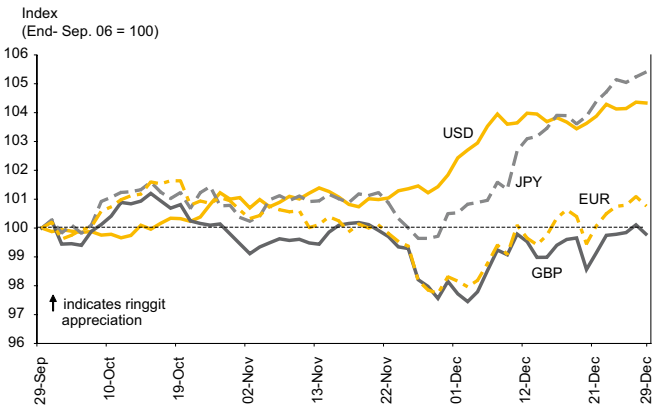
On 19 December, the KLCI declined by 1.96% following the imposition of capital controls in Thailand, but rapidly rebounded to close the year at a higher level. The KLCI rose 128.69 points, or 13.3%, during the quarter (3Q: 52.86 points, or 5.8%) to end the fourth quarter at 1,096.24 points. Market capitalisation was higher at RM848.7 billion (3Q: RM 745.5 billion), while trading activity increased, with the average daily turnover at 934.7 million units during the quarter (3Q: 573.9 million units).

Despite external developments that precipitated a correction on 27 and 28 February 2007, resulting in the market declining by 6%, the KLCI closed at 1196.45 points, 9.1% higher compared to end 2006. Market capitalisation as at 27 February 2007 was higher at RM974.4 billion (since end-December 2006: 14.8%).

Summary of Ringgit Performance Against Selected Currencies Percent Change (1 October - 29 December 2006)



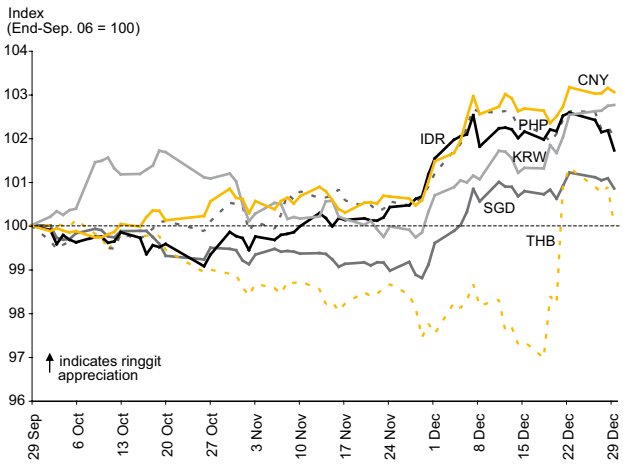
Ringgit Performance Against Major Currencies



Exchange Rate Developments

In the fourth quarter, the ringgit appreciated against the G3 currencies, most significantly in December. The ringgit appreciated against the US dollar as portfolio flows returned to emerging markets, amidst renewed positive investor sentiment towards regional economic prospects. The ringgit strengthened against the Japanese yen amidst weakness in the Japanese yen, due to expectations that the Bank of Japan would normalise domestic interest rate conditions in a measured and gradual manner. The euro subsequency strengthened following market expectations for policy rate increases by the European Central Bank and a positive flow of economic data favouring the euro relative to the US dollar and Japanese yen. In December 2006, there was limited contagion impact on the ringgit arising from the regulatory measures imposed on 18 December 2006 by the Bank of Thailand.

Ringgit Performance Against Regional Currencies



The ringgit appreciated against regional currencies in the fourth quarter, due to the more rapid pace of ringgit appreciation against the US dollar compared with that of other regional currencies. The ringgit appreciated against most regional currencies in the range of 0.8% - 3.0%, while remaining relatively unchanged against the Thai baht.

The ringgit continued its appreciating trend in 2007, as with most regional currencies during the period. For the period 3 January – 28 February 2007, the ringgit appreciated against all major currencies and recorded a mixed performance against regional currencies, appreciating against the Indonesian rupiah (2.8%), Korean won (1.8%), Taiwan dollar (1.8%) and Singapore dollar (0.5%), but depreciating against the Thai baht (0.9%) and remaining relatively unchanged against the Chinese renminbi and Philippine peso.

Performance of Ringgit Against Selected Currencies

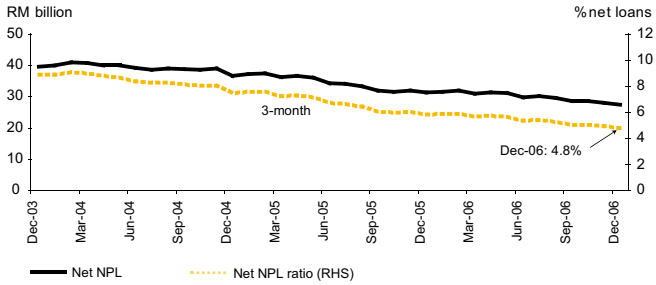
RM per foreign currency	As at end				% change since*		
	21 Jul 05	4Q 05	3Q 06	4Q 06	21 Jul 05	4Q 05	3Q 06
US dollar	3.8000	3.7800	3.6845	3.5315	7.6	7.0	4.3
Euro	4.6212	4.4867	4.6821	4.6460	-0.5	-3.4	0.8
Pound sterling	6.6270	6.5226	6.9171	6.9315	-4.4	-5.9	-0.2
100 Japanese yen	3.3745	3.2229	3.1279	2.9675	13.7	8.6	5.4
Singapore dollar	2.2570	2.2714	2.3221	2.3028	-2.0	-1.4	0.8
100 Thai baht	9.0681	9.2049	9.8109	9.8111	-7.6	-6.2	0.0
100 Philippine peso	6.8131	7.1254	7.3477	7.2027	-5.4	-1.1	2.0
100 Indonesian rupiah	0.0386	0.0385	0.0399	0.0393	-1.6	-2.1	1.7
100 Korean won	0.3665	0.3739	0.3901	0.3797	-3.5	-1.5	2.7
Chinese renminbi	0.4591	0.4686	0.4660	0.4523	1.5	3.6	3.0

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

DEVELOPMENTS IN THE BANKING SECTOR

The banking sector remained resilient amidst sustained profitability and strong capitalisation against the backdrop of favourable macroeconomic developments. Coupled with the continued decline in the level of non-performing loans (NPLs), banking institutions are well-positioned to continue to support the increased economic activity.

Banking System: Non-performing Loans



Banking institutions remained well-capitalised

The risk-weighted capital ratio (RWCR) and core capital ratio (CCR) stood at 12.8% and 10% respectively as at end of the final quarter of 2006. Capital base declined marginally (-1.2%) following the completion of merger between two domestic banking groups during the period.

Banking System: Capital Position

	2005	2006			
	4Q	1Q	2Q	3Q	4Q
Capital					
CCR (%)	10.7	10.0	10.0	10.5	10.0
RWCR (%)	13.7	13.1	12.8	13.2	12.8

Sustained profitability from diversified sources

During the quarter, the banking system recorded a strong growth in the level of pre-tax profit (PBT) totalling RM4.4 billion (+15.6%). This was achieved on account of higher fee income (+12.9%) attained from corporate advisory and remittance services, higher net trading and investment income, as well as lower loan loss provisions for the quarter. This contributed to an overall expansion in PBT for the year totalling RM13.9 billion (+12.7%). As a result, the annualised return on average equity improved to 17.3% (end-2005: 16.7%) while the annualised return on assets was sustained at 1.4%.

Continued decline in the level of NPLs

The NPL level of the banking system continued to record a declining trend during the quarter. Total net NPLs based on the 3-month classification declined further by 4.1% to RM27.4 billion as at end of the fourth quarter to account for 4.8% of total net loans (3Q: 5.1%). This was attributed mainly to the higher recoveries as well as the reclassification of NPLs to performing status, and the continued write-offs by banking institutions.

Malaysia International Islamic Financial Centre (MIFC) Regulators Dialogue with the Financial Industry 1 November 2006, Kuala Lumpur

Keynote Address by

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

The MIFC initiative was launched on 14 August 2006 amidst strong foundation and steady performance of the Islamic financial industry. It marks the beginning of a new era for the future landscape of the Islamic financial system in Malaysia. Several landmark measures were announced to initiate the MIFC agenda. It is to set the stage for Malaysia to position itself as a centre for the offering of Islamic financial products and services in international currencies to the global and domestic financial community. This presents new prospects and business considerations for financial institutions to realise the potential of evolving a vibrant Islamic financial hub.

Today's dialogue, the first of its kind among key stakeholders, is aimed at promoting greater awareness on the initiative, to discuss implementation issues and to foster greater collaborative effort for the MIFC's overall success. We have with us here today the members of the MIFC Executive Committee, the country's high level coordinating body that has been set up to advance forward this national agenda.

Objectives of MIFC

This national agenda aims to achieve several major objectives. As one of the key intermediation linkages in the global market place, the MIFC can have an important role in accelerating the process of bridging and strengthening the relationship between the international Islamic financial markets and thereby expand the investment and trade relations between the Middle Eastern, West Asia and North Africa regions with East Asia. Situated centrally in the Asian time zone, Malaysia is well positioned to effectively serve the East Asian region. Among the key intermediation role for MIFC is to act as a centre for origination, issuance and trading of Islamic capital market and treasury instruments such as sukuks, and to act as an investment gateway to the region specialising in Islamic fund and wealth management, and as a takaful and retakaful centre.

In promoting capital and cross-border trade flows between the financial communities of these regions, it will thereby strengthen the international integration of our domestic Islamic financial system. In addition, this initiative is expected to improve further the performance of the Islamic financial industry and strengthen its competitive edge in this increasingly more challenging global environment.

Currently, assets of the Islamic banking and takaful in Malaysia have been increasing at a double digit growth rate of 19 percent and 25 percent respectively in the recent five years. The Islamic banking and takaful markets which amounted to RM122 billion and RM6.6 billion in assets are among the largest in the world. The Islamic sukuk market has now exceeded RM120 billion and represents the largest Islamic bond market in the world.

Malaysia has developed the comparative advantage in the area of Islamic finance. The comprehensiveness of the Islamic financial system in Malaysia has been mutually reinforcing with the key components of the financial system comprising the Islamic banking, takaful, Islamic money and capital markets now being at an advanced stage of development. In addition, the established legal, regulatory and Shariah frameworks in the Islamic financial infrastructure is also

a key competitive advantage for Malaysia, placing it ahead of other financial centres offering Islamic financial services.

In terms of Shariah governance, it has enabled the development of Islamic finance to be orderly and compliant with the Islamic injunctions, thereby ensuring that customer confidence be maintained. The conducive Shariah environment has also ensured that Malaysia is sustained as a centre of product innovation, producing cutting-edge products for the increasingly sophisticated customers. In respect of Shariah interpretation and practices, the MIFC will adopt a stance of mutual recognition and accommodate the various juristic reasoning that has been approved by recognised Shariah advisers . Next week, Bank Negara Malaysia will again host the 2nd International Shariah Scholars Dialogue, gathering the Shariah scholars from different regions in our endeavour to continuously bridge and foster greater interaction and promote understanding on the issues and challenges faced by the Islamic community on the aspect of Shariah.

Malaysia also has a strong and advanced regulatory regime and legal structure in the Islamic financial system. This was deliberately undertaken since the inception of Islamic finance in this country to sustain the soundness and stability of the system and thus the confidence of the financial community. Reinforcing this is the Islamic Financial Services Board (IFSB) as the international standard-setting body of the prudential and supervisory framework that was established in 2002. The balanced regulatory approach being applied also aims to ensure that the trust and efficiency of doing business is maintained.

In undertaking a holistic approach to drive the MIFC initiative, the Government has streamlined the associated delivery system to facilitate advancing the MIFC agenda with the formation of the MIFC Executive Committee. The Committee comprises a high-level group of 28 top officials from the key relevant Ministries, Government departments and agencies, financial and market regulators and representatives from the banking and takaful sectors. Through the shared vision and commitment, this Committee is responsible for providing the direction as well as undertaking a review of all existing policies that are relevant for the comprehensive and coordinated promotion of the MIFC. Two meetings thus far have been convened and several issues have now been resolved with solutions provided to several key implementation issues which ranged from foreign ownership to immigration policies.

The Secretariat, formed by Bank Negara Malaysia will not only serve the Executive Committee but will also act as a single contact point for the implementation of the MIFC initiatives. Working level committees have also been formed to undertake the task of considering new proposals and monitoring the implementation of the MIFC recommendations. To take into consideration global trends and to provide insights on the strategic direction, an **International Advisory Panel (IAP)** comprising industry leaders and experts from the global community is also being established.

Conducive environment for business

In continuously creating an enabling environment for the efficient functioning of the MIFC, the Government has identified several key strategic objectives. The Government has also granted an attractive tax package to promote Malaysia as a competitive international Islamic financial centre. The objective is to **build the base** - that is, to create the necessary critical mass of participating financial players and to increase the scale of activity. Malaysia aims to attract global players as well as to enhance the capacity and capabilities of the existing financial institutions. Among the measures that have been introduced are:

- first, liberalising the Islamic banking, and takaful and retakaful markets with the issuance of new licences to allow for increased foreign participation;

- second, allowing foreign equity of up to 49 percent in existing Islamic banks and takaful companies;

- third, issuance of International Islamic Bank and International Takaful Operator licences under the Islamic Banking Act and the Takaful Act respectively to qualified foreign and Malaysian financial institutions to conduct the full range of Islamic banking business or takaful and retakaful business in international currencies and enjoy tax holiday for 10 years under the Income Tax Act starting from the year of assessment 2007;

- fourth, granting approval to Malaysian Islamic banks and takaful operators to set up International Currency Business Unit (ICBU) to offer Islamic financial services in international currencies and enjoy similar tax holiday; and

- fifth, provide greater flexibility to the Labuan offshore entities offering Islamic financial services to open operation offices anywhere in Malaysia. The Labuan tax law will continue to be applied to these players.

Players, therefore have the option in participating in the MIFC either by being licensed under Bank Negara Malaysia to benefit from the tax holiday for 10 years under the Income Tax Act and fully benefit from the **Double Tax Agreement**, or alternatively to be licensed under LOFSA and be taxed accordingly under the Labuan Offshore Business Activity Tax Act.

The second strategic objective is **activities generation** - that is, to promote Malaysia as the preferred choice as the centre for the offering of Islamic financial services. Associated with this objective is building the pool of talent and expertise, and to ensure that the environment is cost competitive and conducive for product innovation and product offering. The measures to address this includes:

- first, setting up the International Centre for Education in Islamic Finance (INCEIF). This represents the Malaysia's investment in human capital to support the global development of the Islamic financial services industry;

- second, establishing a Shariah Endowment Fund for scholarships, research and international Shariah dialogues for the regional and international Shariah communities to enhance the harmonisation of Shariah interpretation and practices;

- third, an additional 20 percent exemption in stamp duty on Islamic financial instruments on top of the stamp duty exemption that is currently available to ensure tax neutrality;

- fourth, encouraging Malaysian-owned banks including Islamic financial institutions to expand their operations abroad by allowing the profits of the newly established branches overseas or remittances of new overseas subsidiaries to be given income tax exemption for 5 years. This is to enhance market access and business networking, and also to widen the customer base and to generate new sources of businesses in uncharted territories; and

- fifth, liberalising the foreign exchange administration rules to allow multilateral development banks and multinational corporations to issue ringgit denominated instruments in our domestic bond market.

In further liberalising the market, I am pleased to announce that resident and foreign issuers will now be **able to raise foreign currency-denominated bonds**, in particular, Islamic bonds, in the Malaysian capital market. The foreign issuers eligible to take this opportunity are the sovereigns, quasi-sovereigns, multilateral development banks, multilateral financial institutions and

multinational corporations, while resident issuers are the local MNCs. This represents part of Bank Negara Malaysia's continuous efforts to promote the development of the Malaysian bond market, and to enhance Malaysia as a centre of origination, distribution and trading of sukuks. The issuance of foreign currency denominated bonds will also provide additional flexibility for both residents and foreign investors to diversify their investments into non-ringgit investments in Malaysia .

In taking the MIFC initiative to the next phase of development, I am also pleased to share with you some of the current work-in-progress to this agenda further forward. The International Islamic Bank (IIB) and International Takaful Operator (ITO) will be allowed to be set up as a **branch** in addition to a subsidiary as currently stipulated under the domestic banking and takaful legislation. To create greater international awareness on these new initiatives, financial ambassadors are being appointed to meet with potential players and investors and road shows will be conducted as part of the promotional plan.

In addition, the MIFC Executive Committee is formulating the **supporting immigration policies** with the Immigration Department where long-term employment pass, multiple entry permits, dependent pass and professional visit pass would be offered to expatriates identified as professionals and experts in Islamic finance. To attract specialist and high level expertise, a Permanent Resident status may also be offered based on the recommendation of the relevant financial regulators. A mechanism is also being put in place to ensure the efficient processing of these measures. This is aimed at addressing the acute current shortage of such talent and expertise in the global financial system. While the education infrastructure has already been put in place to address this shortage, Malaysia also needs to be competitive in attracting and retaining the talent. The Executive Committee will therefore look into customised incentives to attract best talents to Malaysia in addition to the entry of international legal firms that are able to provide services for the international currency business in Islamic finance.

Role to be played by financial institutions

One of the key success factors for a vibrant financial hub is having the critical mass of reputable and diversified range of financial institutions. With extensive incentives and measures in place, it is a priority for those already based in Malaysia to be encouraged to be the players in the MIFC. In building the base, the financial institutions in Malaysia, onshore and offshore, are encouraged to develop a niche in the overall landscape for MIFC. Players with expertise in structuring Islamic instruments should capitalise on the tax incentives by having the syndication team to be based in Malaysia for the issuance of ringgit and non-ringgit sukuks out of Malaysia, while those with investment and private banking as well as fund management expertise should intensify their focus on efforts in this area and structure innovative Islamic investment instruments. Existing players are also urged to be MIFC players and develop Malaysia as their regional hub with the potential to have the international currency business operations either through the onshore regulatory framework or under the Labuan offshore structure.

The success of MIFC will depend on the collaborative efforts of the financial regulators, the delivery system, the industry players and the supporting professionals. In meeting the MIFC objectives, we encourage the exploitation of this new growth area. At the onset, it is also emphasized that an equally important part of this process is having the right people in place with the appropriate skills, having in place the appropriate systems and governance framework to ensure the viability and sustainability of this industry.

This dialogue provides the opportunity to deliberate the issues from the different perspectives and dimensions so that the full potential of the MIFC initiatives can be realized.

JP Morgan/Khazanah Nasional Gala Dinner to Commemorate the Sovereign Wealth Funds Roundtable
2 November, 2006, Kuala Lumpur

Keynote Speech by

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

It is my great pleasure to be here this evening to participate in this JP Morgan Round Table event. My remarks this evening will touch on sovereign wealth funds from the perspective of Central Banks, in particular, in the context of emerging market economies.

Why would Sovereign Wealth Funds be of interest to Central Banks? For a number of reasons. Firstly, the source of funds for such investment corporations have important implications. An important potential source of funds for such investment corporations are generally from "windfall gains" from revenues earned from resource booms or from a resource discovery or from increases in world prices. Other sources include carving out funds from the international reserves or from raising the funds from the domestic or international capital markets.
In most emerging market economies the mandate of the Central Bank is much broader than our counterparts in the developed industrialised economies that extends beyond that of monetary and financial stability. In addition, to being financial advisors to the Government, the Central Bank also has a developmental role, in particular, with respect to the development of the financial system and more broadly in the development of the economy.

In emerging market economies such sovereign wealth funds have a role as an important vehicle for managing the national wealth that has been derived from windfall gains from natural resources and to ensure its long-term benefits and optimum usage. The global experience has in fact shown that there is a negative correlation of growth and countries with abundant natural resources. The statistics show that countries with scarce resources grew at two to three times faster than countries endowed with abundant resources. This has been referred to as 'the curse' of natural resources.

The revenues earned from a resource boom can through such a sovereign wealth fund vehicle, be reinvested in other sectors of the economy to promote growth. The stimulus can provide the 'big push' to bring the economy to a higher level of development. The global experience has shown that there are too many examples of cases where such windfall gains have been squandered. King Faisal of Saudi Arabia was quoted in the 1970s as having said that, "In one generation to the next, we went from riding camels to riding cadillacs. The way we are wasting money, I fear the next generation will be riding camels again."

There is therefore a strong case for establishing such sovereign investment corporations to grow the national wealth and spur development and to ensure that the benefits are preserved for the future generations. The Central Bank as financial advisor to the Government has a part in the process of ensuring that this takes place.

The second potential source of funds for such sovereign investment corporations are from what has been termed 'excess foreign reserves'. In the current environment of large accumulation of reserves, this issue has been much discussed. Whether this is a desirable option would depend on the circumstances of the individual economies.

Firstly, there is the issue of reserve adequacy. At the outset it is important to assess the optimal level of reserves that is desirable. This would depend on a number of factors, including the openness of the economy, the extent of capital account liberalization and the exchange rate regime in place. The comfort level of international reserves for an economy like Malaysia where the trade volume is two times the size of its economy would be much higher than a relatively closed economy. In addition, an assessment would need to be made on the extent to which the build up of reserves have been from more permanent sources or whether they are accounted for by short-term inflows.

This growing size of the reserves of several countries has also generated greater scrutiny on the way central banks manage their reserves. Central banks are cognizant of this fact and have moved with the times, adopting increased diversification strategies in terms of asset classes and investment management and placing greater emphasis on returns and upgrading of systems and capacity. This has led to a blurring of the distinction between the reserve management function of central banks and the wealth management function of sovereign wealth funds.

There is however, no single ideal model for managing a country's wealth arising from higher reserves, although Singapore and South Korea have often been cited as examples. In both cases, there is more than one entity managing foreign exchange reserve assets, with different approaches – reserve management and wealth management; the major distinction being that reserve management places greater emphasis on liquidity and short-term capital preservation. There is also the case where such a fund is managed within the central bank itself, as in the case of Norway.

Another important factor that needs to be taken into consideration is the debt status of the country, whether it is a net debtor or net creditor country. For net debtor countries, where the level of international reserves are not sufficient to meet the external obligations, such carve outs would be less desirable. In addition, it needs to be recognized that the use of reserves for public investment is equivalent to deficit financing by the Central Bank and this would contribute to increasing the inflationary risks to the economy. Finally, a strong reserve level would also act as a deterrent for speculative activity.

The third source of funds for such investment corporations is through raising the funds from both the international and domestic financial markets. Being a sovereign investment corporation, their cost of funding will usually be advantageous, perhaps, only marginally higher than the sovereign itself, while the investments undertaken can reap higher returns.

The choice of markets would to a large extent depend on the circumstances such as the investment destination or whether it is for the purpose of establishing a benchmark in the market or developing new instruments or tapping new markets and investors. Recently, Malaysia's sovereign investment corporation, Khazanah, our host tonight raised funds from the international financial markets to enhance its capacity via an Islamic exchangeable bond. Besides achieving their financing objectives, they also introduced a widely accepted Shariah compliant instrument that was well received by global investors. This has supported the efforts to promote Malaysia as an Islamic Financial Centre.

The second area of interest to Central Banks concerns the nature of the investments activities undertaken by such investment corporations. Domestic investments in strategic industries allow public sector investments to be better managed in a sovereign investment corporation compared to by the civil service within the Government. The investment role and function in today's complex and dynamic markets is a very specialized field, and significantly different from the business of the Government. The operating environment is also different requiring a different skills set and

experience. While this makes a case for such investment corporations the governance, risk management systems and required talent needs to be in place. In establishing sovereign investment corporations there has to be a high level of accountability from the outset. Transparency of the funds is also a strong safeguard against misuse and unacceptable risk taking in the activity of the corporation.

One specific concern from the perspective of the Central Bank is the investment by such sovereign investment corporations in the financial services sector. This trend has become increasingly significant in this recent decade. The concern is when governance and competitiveness is affected by the presence of cross shareholding in the financial services sector. Cross shareholding, arising from significant interest in more than one institution would give rise to such conflict of interest. Such a situation would affect the efforts of inculcating strong corporate governance in the financial sector. This development could also affect competitiveness as it could lead to a monopolistic condition. Such a situation can hinder in particular, the development of a healthy and competitive banking sector.

From a regulatory perspective, cross shareholding among banks and other financial institutions also give rise to systemic concerns particularly where the shareholding of banking institutions are concentrated in a few major shareholders. Under stressed conditions, shareholders with an extensive shareholding network may have limited ability to provide further financial support. In addition, cross shareholding also diminishes the influence of minority shareholders, dilutes market pressure and weakens internal discipline.

Finally, it needs to be recognized that in emerging market economies the talents for these such sovereign investment corporations are scarce. Increasing the number of institutions to manage sovereign wealth will increase the demands for the same talent. Competition for this talent is also from the private sector and from the international investment banks. The high degree of mobility of this class of talent increases the challenge of meeting this precondition.

Let me conclude with a few words on our own sovereign investment corporation in Malaysia. As a board member of Khazanah since 2000, I have had the privilege to witness firsthand the transformation of the entity from a passive investment holding company to become a more forward looking and strategic investment institution. The earlier version of Khazanah was essentially an investment holding company entrusted to hold equity on behalf of the government in major companies of what was considered as key industries. As the economic landscape changed with increased globalization and with new emerging growth areas, Khazanah needed to reinvent itself to meet these new challenges.

Implementing change in any organization is always a challenge. For Khazanah, the transformation was required as the changing environment has rendered the then existing model to be no longer relevant. Within this relatively short period of two years, Khazanah has not only refocused to a new strategic direction, but also undertaken organizational transformation and put in place the new systems and mechanisms that are in accordance to international best practices. It is only time that will tell the economic payoff of this transformation.

The World Islamic Economic Forum 2006
7 November 2006, Islamabad, Pakistan

Transcription of Governor's Commentary

Malaysia has been a recipient for more than 100 years for foreign direct investment and I would like to emphasize that the one main factor that prompts foreign direct investment or portfolio investment is the return that is to be gained from that investment.

Malaysia has been a profit centre for foreign direct investment and this has been a factor that has continued to attract such investment. The evidence is in the current account of the balance of payments, where a significant outflow of repatriation of profits and dividends can be seen. Even during the crisis, these investments, including from investments in our financial services sector, were generating positive returns and so this has been the factor.

Very often we talk about how important it is to have financial reform or domestic reform in order to attract investment, but even at our very early stage of economic development, and we were less liberalized in that period, we were already attracting such investment.

Right now, foreign direct investment in our country is important and accounts for one-third to one-quarter of our domestic investment, and it accounts for about 6% of our GDP. This is one of the highest in the world.

What are the benefits that we see from such investments, and are there any important considerations that we need to take into account in attracting such investments? Of course at the initial stage, for us, employment generation was very important. Then of course, there is the transfer of technology and also there are many spill-over effects to support many industries in the domestic economy; it supports the SME sector; it provides us access to markets; and access to research and development.

However there are also other factors that we need to be very complicit about. Such investment, for it to be sustainable over time, such partnerships with foreign entities, need to be mutually beneficial to the investor and to the country. In situations which it marginalizes domestic enterprise, this is a factor that we need to take into consideration, for example when we liberalize our financial services sector.

We need to take into account also the socioeconomic agenda of the nation. For example in Malaysia, where we are multi-racial and multi-religious, we want to have an economy that is inclusive; that everybody benefits from the economic progress that we have gained. We also want to, for example, have a financial system that is inclusive. All target groups, all sectors of economic activities, must participate in this process.

Sometimes when foreign investment comes into our economy, we see very differential development taking place and this is one of the concerns. We want to have balanced growth. With balanced growth comes with it socioeconomic stability.

Many points have been highlighted of what the ingredients, and what the three conditions are to invite foreign investment. I would like to highlight and sum it up into five categories.

Firstly, we must have economic stability. Secondly, monetary stability; and that is an environment of low inflation and where there is predictability of what the future environment would be. Thirdly, financial stability; soundness of the system; efficient functioning of the financial system that can intermediate investments into productive activity. Then, social stability, and finally, politically stability. These are all the stabilities that are important preconditions.

The final point that I would like to make is that our environment is not static; it is dynamic. The environment changes all the time, and therefore if you are to continually attract investment, you need to enhance the flexibility of your economy to adjust to the changing opportunities that exist in the global environment. If you look at Malaysia for example, previously, we were in commodities; then we shifted and transitioned into manufacturing; and now we are major a recipient of foreign direct investments into services sector.

A country therefore needs to know where its comparative advantage lies, and to develop and to carve out these niche areas; and finally for the OIC economies, we need to look at the areas of complimentarities, where we can participate for example, in the globalization of production, in the supply chain of production, so that we can develop new silk road between east Asia and the Middle East and West Asia, whereby we can benefit and strengthen the potential that our economies offer, so that the benefits to all of us will be mutually reinforcing.

Bank Indonesia Annual International Seminar 2006
16 November 2006, Bali

Session 1: "Global Imbalances and Macroeconomic Instability"

Keynote Speech by

Tan Sri Dato'Sri Dr. Zeti Akhtar Aziz
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The global imbalances are a shared concern of the global community in view of the risks that they impose on the international financial system and the global economy. I would like to take this opportunity to discuss these issues from the perspective of Asia. Firstly, to discuss the underlying drivers of the imbalances in Asia and secondly, the potential role Asia might have in the orderly resolution of these imbalances. And finally, the possible strategies that might be adopted to avoid disorderly adjustments, particularly in the event of a crisis.

An understanding of the drivers of imbalances in Asia is important in any assessment of the role that Asia might have in the adjustment process. The global imbalances in Asia have been to a large extent a consequence of the globalization of production. Inflows of foreign direct investment and the relocation of multinational activities into the Asian region have played a major role in driving the pattern of the current account surpluses in Asia. These foreign multinationals produce not just for the Asian market but also for exports to the rest of the world. Their decision to locate their operations in the Asian region is because wages, prices and other costs, including tax structures, are significantly lower in Asia. Asia's aggregate current account surplus therefore, does not reflect the ultimate beneficiaries of this trend. While Asia receives the wage benefits of globalization, the profits from this globalization process accrue to the foreign multinationals. Asia represents a significant profit centre for these multinationals and their investments in Asia in turn have been important in sustaining the current account positions in the region.

Secondly, it is important to recognize the structural nature of the savings–investment gap and hence the current account surplus in Asia. While exchange rate adjustments have been proposed as necessary to the adjustment process, it can only be part of the solution. The structural nature of Asia's current account surpluses is more evident when we disaggregate the savings-investment trends underlying the surpluses into three distinct groups of countries in Asia. In China, while investment activity has been robust, it has however not kept pace with the rise in savings. Under these circumstances, the pattern of aggregate demand is not likely to respond to exchange rate changes.

This is also evident in the case of Japan where the current account surplus has prevailed for more than two decades despite the significant appreciation of its currency. And for the rest of Asia, outside of China and Japan, the rate of savings has not increased but the rate of investment has declined, particularly after the 1997/98 Asian Crisis. This is due to a number of reasons including the restructuring in the domestic corporate sector, the earlier over-investments in the 1990s and the rising overseas investment. In addition, in a number of Asian economies, there has been significant change in the economic structure, resulting in the changing pattern of the investment activity to less capital-intensive activities, including to the services sector. Notwithstanding these trends, the overall rate of investment in emerging Asia (excluding China) as a share of GDP is about 25%. This is still higher than in any other region in the global economy (US 20% of GDP, Euro area 19% and Middle East 22%).

The gap between savings and investment across Asia brings us to the fundamental relationship between global imbalances and the stage of development of the Asian financial system. Financial intermediation has an important role in the savings and investment that take place. The current account surpluses in Asia represent high savings that is not matched by a high rate of investment. Several reasons may explain this. Firstly, it relates to the access to financial services by the population. This includes broad-based access to credit, insurance and pension schemes, as well as availability of social safety nets. This may prompt the need for higher savings. Secondly, the banking system still dominates the financial system in most of the Asian economies. While bank-based systems provide short-term financing, there needs to be a greater role for capital markets to facilitate long-term financing for investment. There continues to be significant investment opportunities in Asia, with infrastructure spending alone being estimated to be about USD 1 trillion over the next five years.

Enhanced financial intermediation and facilitation in Asia will not only narrow the savings-investment gaps in the region, but also more broadly, contribute to the growth prospects of the region. The increase in productive investment within the region will be important in creating jobs and raising incomes, providing a base for more robust private consumption. This will also contribute to stronger domestic demand across Asia. The cumulative aggregate demand in Asia has emerged as an important market. This has accelerated intra-regional trade which now averages 50% of the total trade in the region. This increased economic integration has been mutually reinforcing for the region and this rebalancing of global growth will contribute towards reducing the global imbalances.

Given the significance of the intermediation process, considerable attention has been given to financial market development.

At the national level, these efforts have involved enhancing the domestic financial infrastructure and institutional capacity building. In addition, measures have been implemented to improve the investment climate. In the post the financial crisis period, a more diversified financial system has emerged where the significance of bond markets in a number of Asian economies has increased. This has facilitated the raising of funds for long-term financing. In Malaysia, the bond market currently accounts for almost 90% of GDP with the size of the corporate debt securities market currently exceeding the public debt securities market. This market has been liberalized where non-resident entities are permited to raise domestic and foreign currency bonds in the domestic market. This has led to an increase in the depth and breadth of the market, which in turn further increased the attractiveness of the market as a cost-effective source of funding for the private sector.

Initiatives to improve the quality of corporate governance and increase the level of transparency and information dissemination have also been undertaken. Institutional capacity building, as well as legal, regulatory and supervisory reforms have also gathered momentum. National authorities have also placed greater focus on improving the public delivery systems and removing impediments to private investment. These measures serve to improve the investment climate and promote confidence and commitments for investment. In Malaysia, measures have also been taken to develop new financing channels as well as the supporting infrastructure for small- and medium-sized enterprises (SMEs) and to promote micro-financing for micro-enterprises as part of the effort to promote greater financial inclusion.

At the regional level, initiatives have been undertaken towards enhancing regional financial integration and thus facilitate more efficient allocation of surplus funds in the region into productive investments not only in the region but also to other parts of the world. Greater financial integration would facilitate intra-regional trade and investment. The financial integration process will also contribute towards reducing financing

costs and increase the potential for greater diversification, thus minimising risks and promoting greater regional financial stability.

Various efforts of a regional basis have been taken while more are in the pipeline. These involve measures in four key areas.

Firstly, strengthening the financial infrastructure including developing the regional financial markets and the supporting legal, regulatory and institutional arrangements. Such infrastructure includes regional rating agencies, regional credit guarantee mechanisms, and a regional settlement framework to facilitate cross-border transactions. This has also been reinforced by tax reforms.

Secondly, the progressive removal of impediments to greater cross-border financial transactions**.** The ASEAN Roadmap on Capital Account Liberalisation aims to achieve this. Many of the regional countries, including Malaysia, already have highly liberalised capital account regimes, with all Asian countries now being committed to capital account liberalisation.

Thirdly, the harmonisation of rules and practices that are consistent with international standards and best practices.

Fourthly, the strengthening of cooperation among the regional authorities has been important in reinforcing the private sector's role in the financial integration process. In this regard, regional institutional arrangements are being developed towards increased surveillance and crisis prevention, management and containment.

While Asia is undertaking significant changes to improve financial intermediation in the region, there are still issues that needs to be addressed at the international level in the current global financial architecture. There remains a substantial role for the other major developed economies, particularly Japan and Europe, to facilitate the rebalancing not only of demand but also of global financial flows so as to mitigate the risks to the international financial system. Policies to ensure sustained economic recovery in these economies and maintaining openness to trade would broaden the base of global demand for an orderly adjustment.

The further development of non-dollar markets are also necessary to facilitate more balanced global investment activities and thus reduce the potential for concentrated buildups that would be prone to risks of instability should reversal of financial flows occur. In the current environment, US financial markets are the largest financial markets in the world. It allows for large transactions to occur with minimal impact on market stability. The numbers of players, turnover, and frequency of issues are unmatched in any market. It also has greater diversity of investment opportunities in the different asset classes. This is a major reason prompting investment in these markets. The other major economies can therefore contribute significantly in this area.

While the global community has discussed at length measures needed to promote a gradual and orderly adjustment of the global imbalances, there has been a lack of attention to strategies for ***crisis*** *management* in the event the adjustments become disorderly. Improved surveillance, increased awareness of the risks involved, and instituting pre-emptive strategies among regional authorities to increase the potential for concerted action are some of the initiatives that can be taken to contain the impact of any disorderly adjustments.

Conclusion

The solution to address the global imbalances involves addressing the issue on several fronts, promoting appropriate macroeconomic conditions, structural adjustments, financial reforms, development and stability. By the very nature of the challenge, it is the collective effort of the international community and the individual economies that will produce a long lasting, sustainable solution.

CALENDAR OF EVENTS
October - December 2006

16 October 2006

Governor in her speech at the signing ceremony of the completion of the share subscription agreement between BIMB Holdings Bhd, Bank Islam Malaysia Bhd, Dubai Financial LLC and Lembaga Tabung Haji, said that the new partnership between the parties reflects the confidence the international and domestic investors have in the investment and business climate in Malaysia. She added that capital position of a financial institution was not the only factor that determined its capacity and potential to perform, but of equal importance was the quality of its talent, systems, risk management, ICT systems, governance structure, leadership and corporate culture.

1 November 2006

The Bank held a dialogue between regulators and the players of the financial industry to discuss on various opportunities arising from Malaysian International Islamic Financial Centre (MIFC) initiatives and various tax incentives as announced by the Government in August 2006. In her keynote address, Governor announced that both resident and foreign issuers are now able to raise foreign currency denominated bonds, in particular Islamic bonds (sukuks) in the Malaysian capital market. This initiative will also allow local and foreign investors more flexibility to diversify their investments into non-ringgit denominated investments in Malaysia.

9 & 13 November 2006

The Bank issued two sets of commemorative coins in conjunction with the 50th anniversary of Universiti Teknologi MARA (UiTM) and with the launch of the Ninth Malaysia Plan.

13 November 2006

Bank Negara Malaysia and the Hong Kong Monetary Authority (HKMA) established Asia's first cross-border payment-versus-payment (PvP) link between Hong Kong's US Dollar real time gross settlement (RTGS) system and Malaysia's Ringgit RTGS system. The simultaneous delivery of US Dollar in Hong Kong and Ringgit in Malaysia will eliminate settlement risk arising from the delivery of different currencies in different time zones. Furthermore, it will promote collaboration and cooperation of payment systems between Malaysia and Hong Kong.

15 November 2006

The Bank announced that parties intending to enter into negotiations for the purpose of acquisition or disposal of interest in shares of licensed financial institutions, can now submit their intention with more than one party simultaneously. Under the law, the approval of the Minister of Finance through the Bank is required, prior to signing or finalisation of any agreement or arrangement.

23 November 2006

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

24 November 2006

At its final meeting for 2006, the Bank's Monetary Policy Committee (MPC) decided to leave the Overnight Policy Rate unchanged at 3.50%. In its statement, Bank Negara Malaysia noted that the Malaysian economy will continue on a steady growth path amidst moderating inflationary pressure that is expected to continue into 2007. The schedule of MPC meetings for 2007 was also released.

1 December 2006

The Bank announced the introduction of Bank Negara Monetary Notes (BNMN) to replace the existing Bank Negara Bills (BNB) and Bank Negara Negotiable Notes (BNNN) in order to increase efficiency in managing excess liquidity in the financial market. New issuances of BNMN would be on a discounted or coupon-bearing basis, depending on investors' demand. The first BNMN amounting to RM1 billion was issued on 8 December.

7 December 2006

The Bank announced two additional measures to further develop the Malaysian bond market, namely the introduction of the Callable Malaysian Government Securities (MGS) and the MGS Switch Auction. The Callable MGS allows the Government to redeem the bond ahead of its maturity date, while the MGS Switch Auction allows replacement of previously issued MGS with the current benchmark issues. These measures will further enhance the trading in the secondary market and improving overall liquidity in the bond market.

14 December 2006

The International Centre for Education in Islamic Finance (INCEIF), set up by the Bank in early 2006, was accorded university-status by the Ministry of Higher Education. INCEIF also signed a Memorandum of Understanding with nine local universities to collaborate in the areas of education, training as well as research and development in Islamic finance.

In her speech, Governor said that all parties, including Islamic finance practitioners, educators and researchers, should relentlessly promote the development of Islamic finance into one which is progressive, dynamic, responsive and sustainable. She noted that new research findings in Islamic financial engineering could pave the way for increased innovation of new products, which would contribute towards broadening and deepening Islamic financial markets, and thus strengthen the overall development of the financial industry.

29 December 2006

The Bank and the Securities Commission announced that the rationalisation of the discount house industry has been completed. In addition, the transformation of merchant banks, stockbroking companies and universal brokers into investment banks is expected to be completed by the first quarter of 2007.

Separately, the Bank announced the release of two financial planning tools, namely “Buku Wang Saku” and “Buku Perancangan dan Penyata Kewangan Keluarga” for the year 2007. This is part of the Bank’s on-going effort in educating the public, especially students and parents on the importance of financial planning.