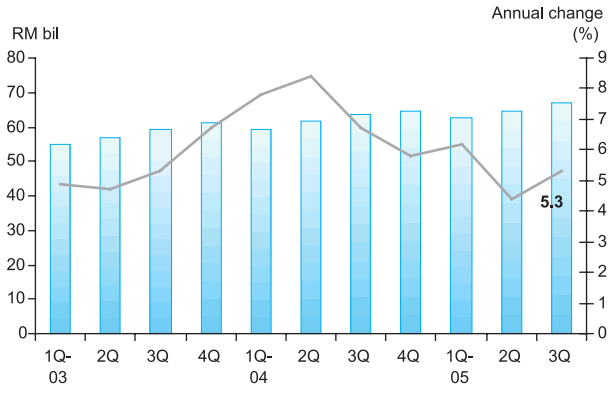
Economic and Financial Developments in the Malaysian Economy in the Third Quarter of 2005

OVERVIEW

Growth strengthened, underpinned by sustained private sector activity…

The Malaysian economy strengthened in the third quarter of 2005, expanding by 5.3%. Private sector activity continued to provide the main impetus to growth.

Stronger real GDP growth in 3Q 2005



Source: Department of Statistics, Malaysia

Domestic demand strengthened, expanding at an annual rate of 9.4%, due mainly to stronger private consumption and investment activities. Private consumption expenditure remained a significant source of growth, expanding by 10.4%. Stable labour market conditions, competitive credit environment and high commodity prices continued to support consumer spending. Major consumption indicators, particularly credit card spending and consumption credit extended, pointed to sustained consumer spending. The number of new passenger cars sold also remained high.

Gross fixed capital formation strengthened to increase by 9.6%. Private sector investments remained strong due to capacity expansion, upgrading, as well as new investments in downstream activities across most sectors of the economy. Growth in private capital spending was evident in the strong growth in imports of capital goods and expansion of lending to the business sector. While Government consumption expenditure increased, Government development expenditure was lower and continued to be focused on the provision of essential services.

Despite the higher petroleum-related expenditure, improved income tax collection by the Federal Government contributed to a lower fiscal deficit of RM805 million or 0.6% of GDP in the third quarter of 2005.

On the supply side, growth continued to be led by the services sector, which expanded by 7.3% during the quarter under review. The sector continued to benefit from strong consumer spending, including spending by tourists, as well as improved business activities. Value added in the manufacturing sector expanded by 3.4% in the third quarter of 2005. Output of the electronics and electrical products (E&E) industry picked up to 3.2%

(2Q 2005: 0.9%), attributable mainly to the strong external demand for computers and computer-related items, as well as the improvement in the global demand for semiconductors. Among domestic-oriented industries, the transport equipment and food products sub-sectors recorded double-digit growth rates, in line with the strong private consumption spending. Meanwhile, industries related to construction continued to contract in tandem with the weak performance of the construction sector.

The primary commodity sector also contributed positively to growth. Value added in the agriculture sector rose by 0.9% during the quarter. The mining sector recorded a growth of 3.4%, supported mainly by sustained increase in natural gas output. Production of crude oil (including condensates) registered a smaller decline of 2.4%. In the third quarter, 745,180 barrels per day were produced compared to 670,520 barrels per day in the previous quarter when several oil fields and plants were closed for maintenance. Meanwhile, the construction sector recorded a smaller decline of 1.4%.

Inflation edged up to 3.4% in the third quarter of 2005, reflecting increases in transport and communication prices, which were affected by the upward revision of retail petrol, diesel and cooking gas prices effective from 1 August 2005. Meanwhile, labour market conditions improved further as indicated by the significantly higher vacancies reported compared with the previous quarter. Sustained growth in labour productivity also supported the strength in the labour market.

On the external front, the trade balance recorded a large surplus of RM23.9 billion (2Q 2005: RM22.9 billion). Gross exports grew by 7.5% in the third quarter of 2005, led mainly by robust growth in exports of minerals (25.8%) and continued expansion in exports of manufactured goods (6.3%). Higher receipts from mineral exports reflected higher prices for crude oil and liquefied natural gas (LNG). LNG export volume also increased during the quarter. Strengthening growth in the E&E industry due to the strong demand for computers and computer-related items and recovery in sales of semiconductors, as well as continued expansion in exports of selected resource-based products, particularly rubber and petroleum products, contributed to the growth in the exports of manufactured goods. Meanwhile, higher agriculture export receipts from rubber, saw logs and sawn timber helped to partially offset the decline in export proceeds from palm oil, which was due entirely to lower prices during the quarter. While lower, export prices of palm oil remained high, averaging at RM1,435 per tonne in the third quarter.

In line with the growth in the exports of manufactured goods, and stronger consumer and investment spending, gross imports grew by 8.1%. Imports of intermediate goods, which were used as raw materials for manufactured goods, expanded at a stronger rate of 6.2%. Imports of capital goods (excluding lumpy items) also increased significantly by 17.4%, with the bulk of the imports being channelled into manufacturing, services, and oil and gas sectors for capacity expansion and upgrading activities.

Reflecting the sustained private consumption spending, imports of consumption goods rose further by 5.3%.

In the financial account, net foreign direct investment (FDI), after adjusting for short-term loan transactions by non-resident controlled companies, recorded an inflow of RM0.9 billion, channelled mainly into the oil and gas, services and manufacturing sectors. The FDI on cash basis does not include retained earnings and investment in the form of imported machinery and equipment. Meanwhile, overseas investment recorded a smaller net outflow of RM1.3 billion, while portfolio investment (equity and debt flows) recorded an outflow of RM0.2 billion.

The net international reserves of Bank Negara Malaysia amounted to RM302.7 billion (USD80.3 billion) as at 30 September 2005. The reserves level has taken into account the quarterly foreign exchange revaluation adjustment, following the strengthening of ringgit against the major currencies. As at 15 November 2005, the reserves amounted to RM285.2 billion (USD75.7 billion), sufficient to finance 8.4 months of retained imports and is 5.7 times the short-term external debt.

Monetary policy continued to support economic growth

The Overnight Policy Rate (OPR) was maintained at 2.70% during the third quarter of 2005. Meanwhile, the daily weighted average of the overnight interbank rate remained relatively stable, moving within a range of 2.66 - 2.73%, and averaging at 2.70% during the quarter.

Gross private sector financing through the banking system and the capital market increased at an annual rate of 7.3% in the third quarter of 2005, resulting from the resilient demand by both businesses and households. On a net basis, banking system loans and PDS outstanding increased at an annual rate of 9.2% at the end of the third quarter of 2005.

Bank lending activity was stronger in the third quarter of 2005, with total loans outstanding expanding at an annual rate of 9.2% at the end of the quarter. Most major loan indicators were higher across the board on an annual and preceding quarter basis. Bank lending to businesses strengthened during the quarter, with loans outstanding growing by 3.9% on an annual basis at the end of the third quarter of 2005. However, bank financing to the small and medium enterprises (SMEs) continued to outpace overall business lending, expanding at a faster annual growth rate of 9.8% at the end of the third quarter. Furthermore, the number of SME accounts which had their loans approved increased to 24,715 during the quarter. Bank lending to households remained resilient, with household loans outstanding growing by 14.9% on an annual basis at the end of the third quarter.

The growth of the monetary aggregates remained broadly in line with the expansion in economic activity. Narrow money, M1, increased at an annual rate of 9.9% at the end of the third quarter of 2005, while, broad money, M3, expanded at an annual rate of 10.9% at the end of the quarter. The main impetus behind the growth of M3 was the higher loans extended to the private sector by the banking system. Government

operations and net external operations were contractionary on M3.

The capital market mobilised RM10.9 billion on a net basis during the third quarter of 2005, due mainly to the higher amount of funds raised from the bond market. The higher amount of gross funds of RM9.7 billion raised in the private debt securities (PDS) market was supported by the prevailing low yields for medium- to long-term bonds. A substantial share of these funds (57.8% of total) were channeled towards financing new activity.

On 21 July 2005, the ringgit peg to the US dollar was replaced with a managed float system. The value of the ringgit is now monitored against a trade-weighted basket of currencies. Since the move to a managed float on 21 July 2005 up to the end of the third quarter of 2005, the ringgit had appreciated against most major and regional currencies. The initial ringgit appreciation against the US dollar following the policy adjustment was however moderated by market expectations of further US interest rate increases.

The banking system remained strong

The financial position of the banking system remained strong in the third quarter of 2005. The risk-weighted capital ratio (RWCR) was 13.3% as at end-September 2005. The banking system also recorded pre-tax profits of RM9.1 billion for the period up to 30 September 2005. This was due mainly to higher income from interest-related and fee-based activities, as well as trading and investment activities. The continued decline in non-performing loans (NPLs) contributed to the improvement in the quality of banking system's assets. Underpinned by higher recoveries and reclassification of NPLs to performing accounts, the net NPLs based on a 6-month classification declined by 2.1% to RM25.5 billion (3-month classification: RM32 billion; -6.9%). With the decline, the net NPL ratio based on 6-month classification improved further to 4.8% (3-month classification: 6.1%).

The near term outlook remains favourable

Prospects for the Malaysian economy in the remainder of the year remain favourable. The global economic expansion is expected to be sustained at a steady pace, despite the high oil prices. The growth momentum in the US has remained strong despite the effects of the hurricanes while the recovery in Japan is becoming more entrenched. Expansion in regional demand is expected to remain strong, supported by the continued improvement in the global electronics cycle and sustained strong growth in P.R. China. The favourable external environment is therefore expected to support the expansion in domestic demand.

Given these developments, the growth momentum in the Malaysian economy is expected to continue into the fourth quarter, supported by both strong external demand and sustained expansion in domestic demand, led by private sector activity. The electronics sector is expected to ride on the current recovery in the global semiconductor industry. Commodity prices are expected to continue to remain at high levels, which would have a positive impact on both exports and private

consumption. Indicators also suggest sustained expansion in private investment activities. The latest DOSM leading index increased, indicating that the economy would continue to expand into the first quarter of 2006.

DEVELOPMENTS IN THE THIRD QUARTER OF 2005

International Economic Environment

Sustained growth in major industrial countries and regional economies, despite high oil prices

The global economy strengthened amidst high oil prices in the third quarter. Growth momentum was sustained in the United States (US) and the People's Republic of China (PR China) and supported by stronger recovery in the euro area and Japan.

The **US** economy remained resilient despite the devastation caused by the hurricanes. Advanced estimate for third quarter showed the economy has expanded by 3.8%, supported mainly by consumer spending and government expenditure. Major indicators, however, showed mixed performance as some data such as jobless claims and unemployment rate were distorted by the hurricane effect. Meanwhile, the **UK** economy recorded a modest growth of 1.6% in third quarter despite a recovery in the manufacturing sector, due mainly to a decline in utilities output and a fall in oil and gas production. The **euro area** economy grew by a stronger-than-expected 1.5% in the third quarter, supported by an export-led expansion in Germany and consumer spending in France. In **Japan**, the economy grew by 1.7%, driven by sustained capital spending and private consumption.

Industrial Countries: Real GDP growth

	2004		2005			Key contributing factors for 3Q growth
	3Q	4Q	1Q	2Q	3Q	
	Annual change in %					
US[1]	4.0	3.3	3.8	3.3	3.8[a]	Stronger-than-expected growth supported by strong consumer spending and government expenditure.
UK	3.0	2.5	1.7[r]	1.5[r]	1.6[p]	A decline in utilities output and a fall in oil and gas production led to more modest expansion despite a recovery in the manufacturing sector.
Euro zone	1.9	1.6	1.3	1.1	1.5[p]	Growth supported by an export-led expansion in Germany and consumer spending in France.
Japan[1]	-0.5	0.4[r]	6.3[r]	3.3	1.7[p]	Recovery on track driven by capital spending and private consumption.

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

Global **crude oil prices** recorded a new peak in the third quarter at USD70.85 p/b on 30 August due mainly to the disruption of oil production and refining capacity in the US Gulf of Mexico by Hurricane Katrina. Oil prices have since declined to range between USD57 - USD60 p/b in the first half of November. Mild weather in the Northern Hemisphere and recovering US oil production have eased fears of a shortage in supply. Nevertheless, oil prices are expected to remain high supported by fundamental factors such as continued strong global demand, especially from the US and PR China, and limited spare production and refining capacity.

The high oil prices had raised concern on rising inflationary pressures among some of the industrial countries. In the US, the Federal Reserve continued to raise

its policy rate by 25 basis points each during its August, September and November meetings to reach 4%. On the other hand, the Bank of England reduced interest rates by 25 basis points to 4.5% on 4 August following the concern of the softening economic growth.

In the **Asian region**, economic growth remained strong with expansion led by PR China and supported by improved performance in other regional countries. Growth was stronger in Hong Kong China, Singapore and Korea compared to the performance recorded in the second quarter. Exports continued to strengthen, supported by a pick-up in demand for electrical and electronics goods.

Regional Countries: Real GDP growth

	2004		2005			Key contributing factors for 3Q growth
	3Q	4Q	1Q	2Q	3Q	
	Annual change in (%)					
PR China	9.1	9.5	9.4	9.6	9.2	Supported by strong investments and exports.
Hong Kong China	6.7	7.2	6.2	7.3	8.2	Driven by strong private consumption expenditure, exports and investment.
Singapore	7.2	6.5	2.7	5.4	7.0	Driven mainly by an upsurge in biomedical manufacturing as well as the transport engineering and chemicals clusters.
Indonesia	5.0	6.7	6.1	5.8	5.3	Supported by private consumption and government spending.
Korea	4.7	3.3	2.7	3.3	4.4	Supported by exports and private consumption.
C. Taipei	5.3	3.3	2.5	3.0	4.4	Due to strong exports.

Source: National authorities

Meanwhile, **inflation** in the region is trending upwards due to higher oil prices and the complete/partial removal of fuel subsidies. Inflation surged to a seven-year high in Thailand following the abolition of a state subsidy for diesel prices in July. In Indonesia, inflation has reached double-digits following the recent hikes in fuel prices. To stem rising inflation, Korea, Thailand, the Philippines, India and Indonesia have raised interest rates, while Singapore has maintained its policy of a 'modest and gradual appreciation' of the Singapore dollar.

In the **currency markets**, the US dollar continued to record broad-based appreciation against the other major currencies. The strength in the dollar was supported by views that the Federal Reserve would continue its policy of monetary tightening. This followed comments by top Fed officials that the economy remained resilient despite the adverse impact from hurricanes. The dollar was also supported by perceptions that it is increasingly a high-yield currency among G7 currencies rather than a funding currency. Meanwhile, most of the regional currencies appreciated in the early part of the quarter following the announcement of the change in PR China's exchange rate regime on 21 July, but weakened subsequently on concerns over the impact of record oil prices on the balance of payments position and growth prospects in particular, for the net oil importing economies.

Going forward, despite the ongoing uncertainties such as high oil prices and potential outbreak of avian flu, the global economic expansion is expected to be sustained at a steady pace. The global economy has greater capacity to absorb the current high energy costs given the higher oil efficiency particularly in the developed countries, lower share of energy in expenditures, and continued income growth. Prospects are also reinforced by the recovery in the global electronic cycle.

Developments in the Malaysian Economy

Economic growth led mainly by the services sector…

The Malaysian economy expanded by 5.3% in the third quarter of 2005 (2Q 2005: 4.4%) driven mainly by the services sector. The services sector contributed 4.2 percentage points to growth during the quarter. Strong spending by domestic consumers and tourists as well as increased business activities supported the growth in the services sector during the quarter. Meanwhile, value added growth in the manufacturing sector was sustained, reflecting improvement in the electrical and electronics industry as well as growth in the chemical and selected domestic-oriented industries such as food products and transport equipment industries. Value added growth in the mining sector was supported by high production of natural gas, while growth in the agriculture sector remained positive, supported by the increase in output of plantation and selected food crops.

Quarterly GDP by Kind of Economic Activity at 1987 Prices

	2004		2005		
	3Q	4Q	1Q	2Q	3Q
	Annual change in %				
Agriculture	4.9	7.3	6.0	3.3	0.9
Mining	4.5	4.4	3.4	-1.5	3.4
Manufacturing	9.9	5.5	5.7	3.1	3.4
Construction	-2.6	-2.6	-2.4	-2.0	-1.4
Services	6.2	6.5	6.9	6.0	7.3
Real GDP (Ann. Chg.)	**6.7**	**5.8**	**6.2**	**4.4**	**5.3**
Real GDP (Preceding Chg.)	**2.7**	**1.9**	**-2.9**	**2.7**	**3.5**

Source: Department of Statistics, Malaysia

Value added in the **services sector** registered a strong growth of 7.3% in the third quarter of 2005 reflecting broad-based expansion in all sub-sectors. Of significance, the wholesale and retail trade, hotels and restaurants sub-sector increased by 10% (2Q 2005: 7.1%), underpinned by strong spending by domestic consumers and foreign tourists especially during the Mega Sales Carnival. The introduction of the five-day working week for the civil servants further contributed to domestic tourism and consumer spending during the quarter. Meanwhile, tourist arrivals recorded a higher growth of 5.9% during the quarter (2Q: 2.5%). In addition, the distributive trade activity in the motor vehicles segment was also robust supported by the launch of new models and aggressive marketing by car dealers.

The transport, storage and communication sub-sector grew by 3.8%, supported mainly by the favourable performance of the telecommunications industry, and continued increase in transport activities, particularly air passenger transport and port activities. The aggressive marketing by major telecommunication companies resulted in an increase of close to one million new cellular phone subscribers and 77,000 new broadband subscribers during the quarter. Growth in the finance, insurance, real estate and business services sub-sector was supported by strong bank lending and insurance activities, particularly general insurance. The sub-sector also benefited from rapid growth in new activities such as shared services and outsourcing activities and the increased trading activity in the stock market. Government services expanded by 10.2% during the quarter due to higher emoluments partly as a result of the increase

in allowances for selected civil service. Meanwhile, increased demand for electricity from major categories of users, namely commercial and household categories, supported growth of the electricity, gas and water sub-sector.

Performance in the Services Sector (Value Added)

	Share 2004	2004		2005		
		3Q	4Q	1Q	2Q	3Q
	%	Annual change in %				
Intermediate Services	**41.5**	**6.2**	**6.9**	**6.9**	**5.0**	**5.5**
Transport, storage & communication	15.3	7.6	9.3	10.4	5.5	3.8
Finance, insurance, real estate & business services	26.3	5.5	5.6	4.8	4.7	6.5
Final Services	**58.5**	**6.1**	**6.3**	**6.9**	**6.7**	**8.6**
Electricity, gas & water	7.2	8.0	7.3	5.9	6.0	6.6
Wholesale & retail trade, hotel & restaurants	24.9	6.0	6.9	7.7	7.1	10.0
Government services	12.8	7.0	7.2	8.4	8.3	10.2
Other services	13.6	4.5	3.7	4.7	4.9	5.7
Total Services	**100**	**6.2**	**6.5**	**6.9**	**6.0**	**7.3**

Source: Department of Statistics, Malaysia

Selected Quarterly Indicators in the Services Sector

	2004		2005		
	3Q	4Q	1Q	2Q	3Q
	Annual change (%)				
Tourist arrivals	51.5	15.4	4.6	2.5	5.9
Total passenger traffic at all airports	15.2	11.2	6.6	5.5	4.7
Total consumption credit outstanding	14.7	16.4	17.4	18.0	18.6
Loans outstanding to the wholesale & retail trade, restaurants & hotels	9.5	11.0	12.7	12.6	12.6
Imports of consumption goods	38.8	16.4	10.7	4.3	5.3
Total sales of passenger cars	21.6	27.3	13.7	-1.2	-2.8
Total sales of commercial vehicles	25.3	39.3	57.1	47.3	65.8
Cellular phone penetration rate (%)	50.8	56.5	60.9	63.3	66.8
SMS traffic	53.0	77.8	70.6	91.0	142.1
Cargo handled (all airports)	13.7	10.2	5.3	5.3	0.3
Container cargo handled (Port Klang and PTP)	8.8	3.6	4.7	2.1	5.2

Source: various sources

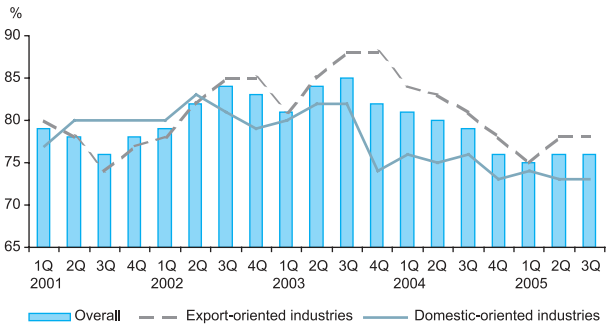
Sustained expansion in the manufacturing sector…

Value added in the **manufacturing sector** expanded by 3.4% in the third quarter of 2005 (2Q 2005: 3.1%). The growth in the **export-oriented industries** was sustained at 4.1% (2Q 2005: 4.1%), supported by the pick-up in the electronics and electrical products (E&E) industry. During the quarter, output of the E&E industry increased by 3.2% (2Q 2005: 0.9%), attributable to the strong demand for computers and computer-related items partly benefiting from the worldwide migration to portable and wireless computers as well as the improvement in the global semiconductor industry. The expansion in the chemical products industry was supported by the strong expansion in synthetic resins and plastic products sub-sector, while the textile industry recovered led by the wearing apparel sub-sector. In line with the modest expansion in crude palm oil production, off-estate processing activity registered a more moderate growth of 7.3% during the quarter (2Q 2005: 18.9%).

In the **domestic-oriented industries**, the transport equipment sub-sector continued to expand at a robust pace of 12.7% (2Q 2005: 10.1%), supported by the strong demand for motor vehicles, stimulated by the launch of new models as well as the ongoing attractive loan packages. Similarly, output of the food products industry increased by a double-digit growth of 11.4% (2Q 2005: 6%) supported by strong domestic consumption. Meanwhile, industries that are related to the construction sector, namely the iron and steel, non-metallic

mineral products, and fabricated metal industries, continued to contract in tandem with the subdued performance of the construction sector.

Capacity Utilisation in the Manufacturing Sector



Performance in the Manufacturing Sector

	2004		2005		
	3Q	4Q	1Q	2Q	3Q
	Annual change (%)				
Value Added (Constant Price)	**9.9**	**5.5**	**5.7**	**3.1**	**3.4**
Overall Production	**11.6**	**7.5**	**5.6**	**2.8**	**2.9**
Export-oriented industries	**12.8**	**7.8**	**5.4**	**4.1**	**4.1**
Of which:					
Electronics and electrical	19.3	5.1	-1.2	0.9	3.2
Electronics	27.0	9.6	-0.1	2.9	5.9
Electrical	-8.8	-13.8	-7.1	-9.2	-10.5
Chemicals and chemical products	8.7	13.3	16.0	10.8	8.9
Wood and wood products [1]	11.3	5.1	-3.4	-6.6	-5.5
Textiles & wearing apparel	-13.8	-14.5	-4.4	-4.6	5.8
Off-estate processing	1.5	17.9	24.6	18.9	7.3
Rubber products	7.5	9.1	10.9	-0.2	-3.9
Domestic-oriented industries	**7.2**	**6.3**	**6.4**	**-1.3**	**-1.4**
Of which:					
Non-metallic mineral products	-4.6	-4.8	-3.6	-4.1	-1.3
Fabricated metal products	38.0	21.4	15.9	-12.7	-14.6
Iron & steel and non-ferrous metal	-1.9	4.7	-3.6	-6.1	-9.8
Food	-1.8	-0.5	2.3	6.0	11.4
Transport equipment	6.4	17.8	13.5	10.1	12.7
Petroleum products	7.1	5.4	10.4	5.8	5.0
Total Manufactured Exports	**27.3**	**13.5**	**12.0**	**9.3**	**6.3**
Of which:					
Electronics and electrical products	21.3	7.5	9.9	8.7	6.8
Chemical and chemical products	43.6	26.9	20.7	3.4	1.3
Petroleum products	66.8	57.1	18.0	45.8	19.4
Optical & scientific equipment	40.5	19.6	22.9	-4.3	-0.7
Wood and wood products	47.1	12.4	16.8	4.6	-14.9
Furniture & parts	24.5	16.2	10.3	11.9	3.0
Rubber products	21.3	14.5	11.9	8.5	10.0

[1] Output of furniture and parts are not captured in the wood production data.
Source: Department of Statistics, Malaysia

The **overall capacity utilisation** of the manufacturing sector remained unchanged from the second quarter level of 76%, with both the export-oriented and domestic-oriented industries operating at 78% and 73% respectively (2Q: 78% and 73% respectively).

Positive contribution from the commodity sector…

The primary commodity sector contributed positively to growth during the third quarter of 2005. The agriculture sector grew by 0.9% (2Q 2005: 3.3%) reflecting slower growth in palm oil output which was partly offset by higher production of other activities including rubber, livestock, aquaculture and other agriculture such as paddy and vegetables. Value added in the mining sector strengthened, increasing by 3.4% (2Q 2005: -1.5%) due entirely to a significant increase in natural gas output. Meanwhile, crude oil production declined, albeit at a slower rate than in the previous two quarters.

In the **agriculture sector**, production of crude palm oil registered a marginal increase of 0.2% during the quarter. The small increase in production growth was attributed to lower yields of fresh fruit bunches (FFB) compared to the exceptionally high levels recorded in the corresponding period of 2004. Yields in terms of FFB declined by 4.3% to 5.14 tonnes per hectare (3Q 2004: 5.37 tonnes per hectare). Nevertheless, the contraction was partially offset by the sustained rise in the oil extraction rate (OER), which increased to 20.17% (3Q 2004: 20.11%). Thus, the monthly average production of crude palm oil was maintained at

1.36 million tonnes (3Q 2004: 1.36 million tonnes) resulting in total production of 4.09 million tonnes for the quarter (2Q: 3.75 million tonnes, 1Q: 3.42 million tonnes).

Rubber production rose by 3.7% after two consecutive quarters of decline, as latex output recovered from the adverse effects of drought seen in the first half of the year. In addition, smallholders who account for 95% of Malaysia's rubber output, accelerated tapping activities, induced by the remunerative prices of above 500 sen per kilogramme quoted during the quarter (552 sen per kilogramme; 2Q 2005: 467 sen per kilogramme). The recovery from excessively dry weather conditions seen in the earlier quarters was also reflected in higher output of food crops, such as paddy and vegetables, during the quarter. Aquaculture products recorded a significant rise during the quarter, rising by 13.2%, reflecting the rise in demand, both domestic and external, for products such as seaweed, ornamental fish and surimi.

Growth in the **mining sector** was driven entirely by significant increase in natural gas production, which expanded at a double-digit rate of 15.9% to 5,363 million standard cubic feet per day. The stronger production was a result of the commencement of output from several new gas fields offshore

Performance of the Agriculture Sector

	2004		2005		
	3Q	4Q	1Q	2Q	3Q
	Annual change (%)				
Value Added (at 1987 prices)	**4.9**	**7.3**	**6.0**	**3.3**	**0.9**
Production [1]					
Of which:					
Crude palm oil	5.2	16.5	27.5	14.5	0.2
Crude palm kernel oil	-3.5	11.8	27.2	25.1	7.8
Rubber	20.7	7.2	-9.2	-6.0	3.7
Saw logs	5.3	2.7	-2.2	-16.8	-12.9
Cocoa beans	17.7	17.9	-10.9	-29.9	-19.0
Exports (RM million)	**4.2**	**1.2**	**6.2**	**4.9**	**-0.1**
Of which:					
Palm oil					
('000 tonnes)	-14.0	2.3	13.9	28.6	4.8
(RM/tonne)	5.9	-6.1	-15.7	-21.2	-13.5
(RM million)	-8.9	-3.9	-4.0	1.4	-10.0
Palm kernel oil					
('000 tonnes)	-39.9	-24.7	14.5	-0.8	-14.3
(RM/tonne)	55.9	38.9	8.3	-4.3	-5.8
(RM million)	-6.4	4.5	24.1	-5.1	-19.2
Rubber					
('000 tonnes)	15.3	16.6	-0.8	5.3	4.4
(Sen/kilogramme)	29.0	2.6	-2.2	-3.2	13.0
(RM million)	48.7	19.6	-2.9	2.0	18.0
Sawn timber					
('000 cu.metres)	15.3	16.3	47.8	15.8	9.1
(RM/cu.metre)	-1.9	-10.2	-10.3	18.7	5.7
(RM million)	13.1	4.4	32.6	37.5	15.3
Saw logs					
('000 cu.metres)	22.8	-17.9	42.2	13.7	-4.4
(RM/cu.metre)	7.3	6.2	4.4	-3.6	14.7
(RM million)	31.8	-12.8	48.4	9.7	9.7
Cocoa beans					
('000 tonnes)	53.8	-15.6	183.4	-15.8	-77.6
(RM/tonne)	-5.8	-5.9	0.7	-6.9	18.6
(RM million)	44.8	-20.6	185.3	-21.6	-73.4

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

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

Performance of the Mining Sector

	2004		2005		
	3Q	4Q	1Q	2Q	3Q
	Annual change in %				
Value Added (at 1987 prices)	**4.5**	**4.4**	**3.4**	**-1.5**	**3.4**
Production					
Of which:					
Crude oil and condensates ('000 barrels)	5.4	1.4	-5.2	-9.2	-2.4
Natural gas (net) (million standard cubic feet)	-1.5	10.3	19.8	12.1	15.9
Exports (RM million)	**50.1**	**44.7**	**34.8**	**30.1**	**25.8**
Of which:					
Crude oil & condensates					
('000 tonnes)	7.8	-11.0	-1.1	-5.3	-9.4
(USD/barrel)	50.6	53.3	36.0	43.4	42.5
(RM million)	62.3	36.4	34.5	35.7	29.0
Liquefied natural gas					
('000 tonnes)	8.9	19.4	17.6	2.5	5.7
(RM/tonne)	11.7	15.9	12.8	14.0	16.8
(RM million)	21.7	38.5	32.7	16.8	23.4

Source: PETRONAS
Department of Statistics, Malaysia

Peninsular Malaysia and Sabah which, in turn, resulted in higher capacity utilisation rates at the Malaysia Liquefied Natural Gas (MLNG) plants in Sarawak and Gas Processing Plants (GPPs) in Peninsular Malaysia. The pick-up in output was in response to the higher demand requirements from domestic buyers including power generators and industrial users, as well as by external buyers. Production of crude oil (including condensates) registered a smaller decline of 2.4%. In the third quarter, 745,180 barrels per day were produced compared with 670,520 barrels per day in the previous quarter when several oil fields and plants were closed for maintenance purpose.

Construction activity supported by residential segment

The construction sector contracted, albeit at a slower rate of 1.4% in the third quarter of 2005 (2Q 2005: -2%). Civil engineering activity remained subdued for a number of quarters following the completion of several large infrastructure projects. Thus, construction companies have expanded abroad and secured overseas projects, including low-cost housing in Thailand, hydropower plant in Laos, airport in Qatar and highway projects in India and Bosnia. In the residential segment, demand was sustained by high disposable incomes and competitive credit environment. In the non-residential segment, demand for office and retail space continued to be supported by business activities. Going forward, the construction sector is expected to improve, benefiting from higher development expenditure announced in the 2006 Budget as well as measures taken to accelerate some of the projects under the Ninth Malaysia Plan.

Construction Indicators

	2004		2005		
	3Q	4Q	1Q	2Q	3Q
	Annual change (%)				
New sales and advertising permits	-31.9	-19.4	2.3	10.1	45.4
Housing approvals	-30.7	-34.9	11.2	-26.9	2.4
Production of construction-related materials	-3.4	-0.4	-3.6	-5.1	-5.2
Loans approved for construction	39.0	14.8	47.6	-14.5	-4.0
Imports of construction materials & mineral products	86.9	15.8	6.1	-5.7	-20.1*

* *July-August 2005*

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

Private sector continues to drive growth

Domestic demand strengthened in the third quarter, registering an annual growth of 9.4%. Private sector spending continued to support the growth momentum.

GDP by Expenditure Components (at Constant 1987 prices)

	2004		2005		
	3Q	4Q	1Q	2Q	3Q
	Annual change (%)				
Aggregate Domestic Demand (excluding stocks)	7.0	6.7	6.5	6.2	9.4
Consumption	8.7	8.6	8.4	5.9	9.3
Private sector	11.2	10.2	10.1	7.4	10.4
Public sector	1.1	4.2	1.5	0.9	5.9
Gross Fixed Capital Formation	3.2	2.2	2.0	6.7	9.6
Exports of Goods and Services	19.0	10.2	9.5	7.9	5.7
Imports of Goods and Services	24.3	12.9	7.6	6.9	7.4
GDP	**6.7**	**5.8**	**6.2**	**4.4**	**5.3**

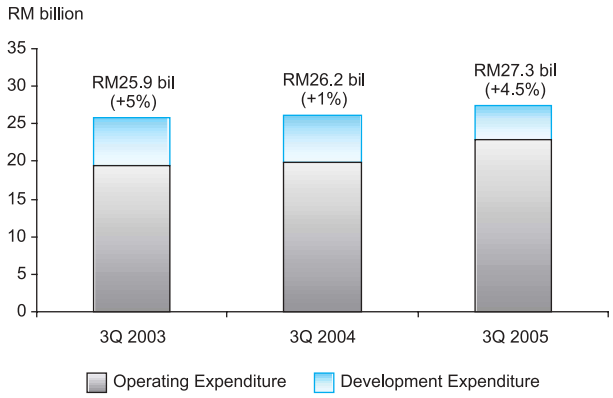
Source: Department of Statistics, Malaysia

Private consumption growth strengthened in the third quarter to 10.4% (2Q: 7.4%). The stable labour market conditions, competitive credit environment and

high commodity prices were factors supporting consumer spending. Major consumption indicators, particularly financial indicators such as credit card spending and consumption credit extended, pointed to sustained expenditure. The number of new passenger cars sold also remained high, partly the result of the aggressive marketing campaigns and the launch of new models.

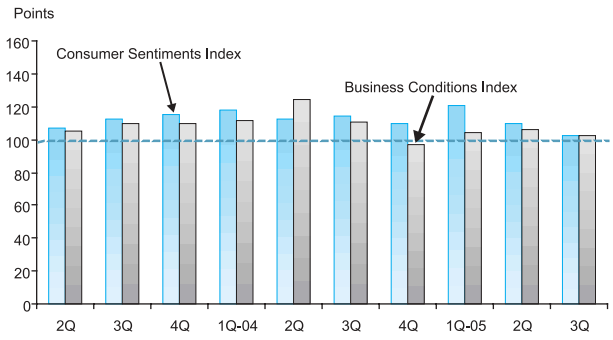
Meanwhile, **public consumption** registered higher growth due to higher expenditure on emoluments and supplies and services.

Moderate Levels of Federal Government Spending



Gross fixed capital formation strengthened to increase by 9.6% (2Q 2005: 6.7%). Private sector investments remained strong due to capacity expansion, upgrading, as well as new investments in downstream activities across most sectors of the economy. Major investment indicators pointed to sustained investment in the manufacturing and services sectors as well as oil and gas sub-sector. This was reflected in the growth of capital imports for use in these sectors. Other indicators, such as loans disbursed to businesses and sales of commercial vehicles, also pointed to sustained investment activities. While lower, Government development expenditure continued to focus on provision of essential services, such as transportation, agriculture and rural development, education, housing, healthcare and public utilities.

Consumer and business confidence remain optimistic



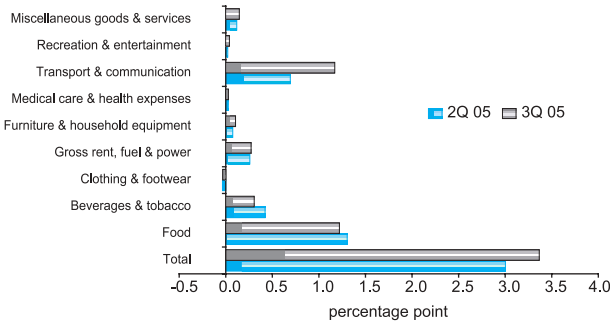
Inflation increased during the period

The annual rate of inflation, as measured by the **Consumer Price Index** (CPI), increased to 3.4% in the third quarter of 2005 (3% in 2Q 2005). The increase in third quarter inflation was caused mainly by the higher increase of prices in the transport and communication category, which was in turn affected by the upward revision of retail petrol, diesel and cooking gas prices that came into effect on 1 August 2005.

The **Producer Price Index** (PPI) increased at an annual growth of 9% (6.2% in 2Q 2005), driven by higher prices of crude oil

and rubber, which more than offset the decline in prices of crude palm oil. Excluding commodities, the PPI, however, increased by 2.4% (2.2% in 2Q 2005), due mainly to higher prices of food and live animals.

Contribution to Inflation



Higher job vacancies and a decline in registered jobseekers indicate healthy labour market conditions

Labour market conditions in the third quarter remained healthy as job vacancies continued to rise while the number of registered jobseekers declined.

A total of 77,578 vacancies were reported to authorities over the course of the quarter, significantly higher than the 28,715 positions reported in the second quarter as the manufacturing and services sectors continued to expand. Mirroring the growth in unfilled vacancies, the number of jobseekers registered with authorities declined in September. The number of registered jobseekers peaked at 104,714 persons at end-August 2005 before declining by 1.8% by end-September to 102,795 (end-June: 82,708).

However, retrenchments increased during the third quarter to 4,875 persons (2Q: 2,570 persons). Nevertheless, this level remains lower than the average of 4,989 retrenchments per quarter recorded over the course of 2004.

Labour productivity growth continued to remain positive and outpaced growth in wages. Real labour productivity during the quarter, as measured by real sales value per employee in the manufacturing sector, rose by 8.8% (2Q: 9.6%) while the real wage rate increased by 1.1% (2Q: -0.4%).

Labour Market Indicators



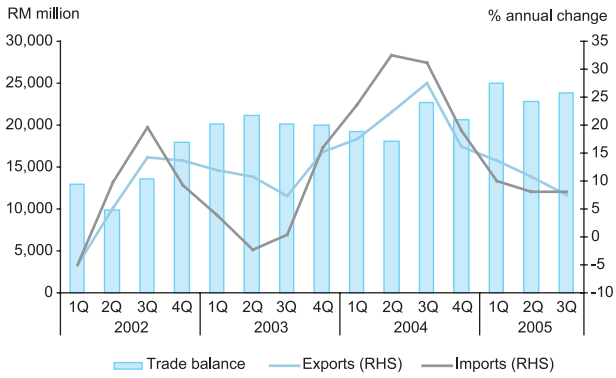
Continued growth in both exports and imports

Consistent with growth in manufactured and mineral exports, the trade account recorded a large **trade surplus** of RM23.9 billion (2Q 2005: RM22.9 billion) in the third quarter.

Gross Exports

Gross exports increased by 7.5% in the third quarter of 2005 (2Q 2005: 10.8%) led

Trade Balance



mainly by robust growth in mineral exports and continued expansion in manufactured exports. Meanwhile, agriculture exports declined marginally during the quarter.

Exports of **manufactured goods** increased by 6.3% (2Q 2005: 9.3%), supported by a continued expansion in the electrical and electronics products industry (6.8%, 2Q 2005: 8.7%). Of significance, growth in exports of electronic equipment and parts remained strong at 19.2% (2Q 2005: 21.6%), underpinned by higher shipment of computers and computer-related products to the US and the regional countries. Among the selected resource-based products, exports of rubber products increased further by 10% (2Q 2005: 8.5%) due to importers stocking up rubber gloves in anticipation of higher latex prices in the near term. Exports of petroleum products also expanded strongly by 19.4%, buoyed by both the high prices and robust demand from the regional countries. During the quarter, export volume of manufactured goods increased by 7.7% while export unit value fell by 1.3%.

Mineral exports continued to grow at a robust pace of 25.8%, mainly benefiting from higher prices. International crude oil prices continued on its upward trend to reach new highs, exceeding the USD60 per barrel level on average during the quarter. The tight global supply situation was further aggravated by the prolonged shutdown of several oilrigs and refineries in the US following the damage caused by the two major hurricanes in the country. Consequently, Malaysian export prices of crude oil increased markedly by 42.5% to average USD61.26 per barrel. The Malaysian Tapis Blend, the benchmark premium grade crude reached a record high of USD70.30 per barrel on 30 August and remained range bound at a high level of between USD65 - 69 per barrel until the end of September. Exports of liquefied natural gas (LNG) rose by 23.4% due to both increases in prices (16.8%) and volume (5.7%). In line with strong demand in the major energy markets, LNG prices hit a new monthly high of RM1,007 per tonne in September 2005.

Agriculture exports declined, albeit marginally, by 0.1% (2Q 2005: 4.9%), due mainly to lower palm oil exports. This was partially mitigated by increased export receipts from other commodities, such as rubber, saw logs and sawn timber. Proceeds from palm oil, the largest agriculture export product, declined by 10% during the quarter due entirely to lower prices (-13.5%) which averaged RM1,435 per tonne, compared to the high level seen during the corresponding period of 2004 (3Q 2004: RM1,660 per tonne). Nevertheless, export volume remained strong, rising by 4% due to higher

demand from PR China and the United States. Rubber exports rose by 18%, supported by higher prices (13%), as well as increased demand for natural rubber from major industries, particularly the automotive industry as prices of the competing synthetic rubber became expensive due to higher crude oil prices.

Malaysia's trade with major trading partners continued to grow. Exports to the United States (US) grew by 15.8% to account for a higher export share of 21%. Exports to the US were underpinned by the replacement cycle to wireless computers and laptops. Consequently, the trade surplus with the US increased to RM14.5 billion (2Q 2005: RM12.5 billion).

Exports to regional countries recorded a growth of 6.2%, supported by export growth to Singapore, Thailand, Indonesia and Hong Kong China. Exports to Thailand were supported by strong demand for office machine parts, computers and components, iron and steel and optical and scientific equipment, while Singapore continued to source machinery, appliances and parts and rubber products from Malaysia. Exports to Hong Kong China were attributable to higher demand for integrated circuits, chemical products and plastics. During the quarter, Malaysia has also recorded stronger export growth to India and Australia, supported mainly by mineral exports.

Trade Account

	2004		2005		
	3Q	4Q	1Q	2Q	3Q
	Annual change (%)				
Gross Exports	**27.5**	**16.1**	**13.7**	**10.8**	**7.5**
Manufacturing	*27.3*	*13.5*	*12.0*	*9.3*	*6.3*
Agriculture	*4.2*	*1.2*	*6.2*	*4.9*	*-0.1*
Minerals	*50.1*	*44.7*	*34.8*	*30.1*	*25.8*
Gross Imports	**31.1**	**19.1**	**10.1**	**8.0**	**8.1**
Capital goods	*38.4*	*37.2*	*0.7*	*16.3*	*17.6*
Intermediate goods	*25.5*	*13.5*	*10.6*	*5.9*	*6.2*
Consumption goods	*38.8*	*16.4*	*10.7*	*4.3*	*5.3*
Trade balance (RM bil)	**22.7**	**20.6**	**25.0**	**22.9**	**23.9**

Source: Department of Statistics, Malaysia

Malaysia: Direction of Exports

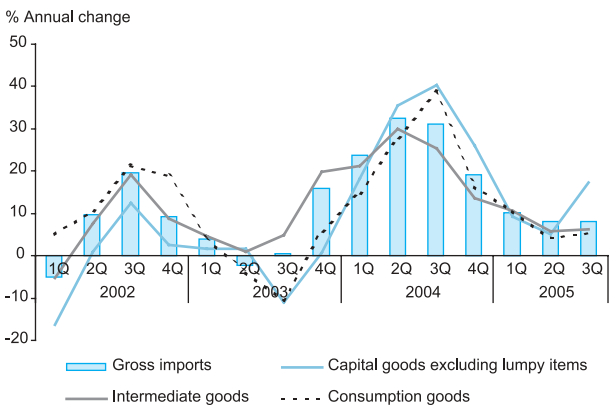
	2004		2005			2004		2005			2004		2005		
	3Q	4Q	1Q	2Q	3Q	3Q	4Q	1Q	2Q	3Q	3Q	4Q	1Q	2Q	3Q
	RM billion					Share of total exports (%)					Annual change (%)				
United States	**25.0**	**23.2**	**21.6**	**27.0**	**28.9**	**19.5**	**18.3**	**17.6**	**20.6**	**21.0**	**25.7**	**9.8**	**12.2**	**18.4**	**15.8**
European Union (EU)	**16.1**	**15.7**	**14.6**	**15.0**	**15.5**	**12.6**	**12.4**	**11.9**	**11.5**	**11.2**	**28.9**	**18.4**	**5.3**	**2.6**	**-4.0**
Selected ASEAN countries[1]	**31.9**	**32.0**	**32.6**	**33.8**	**34.8**	**24.8**	**25.3**	**26.6**	**25.8**	**25.3**	**32.2**	**18.2**	**20.9**	**16.9**	**9.3**
North East Asia	**24.1**	**24.3**	**23.5**	**24.1**	**24.6**	**18.8**	**19.2**	**19.2**	**18.4**	**17.8**	**22.8**	**11.5**	**7.3**	**4.2**	**2.2**
People's Republic of China	*8.6*	*8.3*	*8.0*	*8.3*	*8.5*	*6.7*	*6.6*	*6.5*	*6.3*	*6.2*	*28.3*	*8.9*	*10.8*	*2.4*	*-0.8*
Hong Kong China	*7.4*	*7.3*	*7.1*	*7.9*	*8.4*	*5.8*	*5.8*	*5.8*	*6.1*	*6.1*	*7.1*	*6.4*	*9.7*	*5.2*	*13.8*
Chinese Taipei	*4.2*	*4.1*	*3.1*	*3.8*	*3.9*	*3.3*	*3.2*	*2.5*	*2.9*	*2.9*	*14.9*	*7.4*	*-14.4*	*-1.4*	*-6.7*
Korea	*3.9*	*4.6*	*5.4*	*4.1*	*3.7*	*3.0*	*3.6*	*4.4*	*3.2*	*2.7*	*66.0*	*32.0*	*14.9*	*11.8*	*-3.7*
India	**2.8**	**3.2**	**3.7**	**3.3**	**3.9**	**2.2**	**2.5**	**3.0**	**2.5**	**2.8**	**24.3**	**17.4**	**37.0**	**19.0**	**36.4**
Total exports	**128.2**	**126.7**	**122.6**	**130.7**	**137.9**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**27.5**	**16.1**	**13.7**	**10.8**	**7.5**

[1] Singapore, Thailand, Indonesia, Philippines, Brunei Darussalam and Vietnam
Source: Department of Statistics, Malaysia

On the imports side, Malaysia continued to source imports from Japan, PR China, Singapore and the US. PR China has increasingly become a major source of intermediate imports for Malaysia, mainly automatic data processing machines, computers and parts, integrated circuits and optical equipment. With a higher growth of 30.9%, imports from PR China accounted for a larger share of 12.5% of Malaysia's total imports (2Q 2005: 10.9%).

The growth in **gross imports** of 8.1% was due mainly to import of inputs for manufactured exports as well as stronger consumer and investment spending. Imports of **intermediate goods**, which were used as raw materials for manufactured goods, expanded at a stronger rate of 6.2% (2Q 2005: 5.9%) in line with expansion in E&E exports and resource-based products such as chemicals. Growth in the motor assembly industry led to higher imports of parts and accessories of transport equipment. Strong growth of imports of fuel and lubricants reflected high oil prices.

Import Growth



Imports of **capital goods** picked up to expand by 17.6%, rising after a second quarter growth of 16.3%. Imports of capital goods excluding lumpy items increased significantly by 17.4%. The bulk of capital imports were channelled into manufacturing, services and oil and gas sectors for capacity expansion and upgrading. In the manufacturing sector, imports of machinery for the electrical and electronics and iron and steel industries increased during the quarter. Higher capital imports by the airline, shipping industries, the marine, power generation and oil and gas sectors reflected the capacity expansion undertaken in these sectors. Imports of office equipment also increased. The extension of network infrastructure and new technologies by telecommunication companies led to growth in imports of telecommunication

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

	2004		2005		
	3Q	4Q	1Q	2Q	3Q
	Annual change (%)				
CAPITAL GOODS	**38.4**	**37.2**	**0.7**	**16.3**	**17.6**
Capital goods (except transport equipment)	27.6	30.4	7.3	8.8	19.4
Transport equipment	292.6	90.8	-43.0	147.1	3.7
INTERMEDIATE GOODS	**25.5**	**13.5**	**10.6**	**5.9**	**6.2**
Food and beverages, mainly for industry	58.7	25.1	-7.9	-12.6	-6.7
Industrial supplies, n.e.s.	53.6	29.2	16.0	7.5	1.9
Fuel and lubricants	76.4	68.4	95.7	41.6	24.5
Parts and accessories of capital goods (except transport equipment)	8.3	-0.3	0.1	-0.5	5.0
Parts and accessories of transport equipment	36.0	38.9	40.9	56.3	39.5
CONSUMPTION GOODS	**38.8**	**16.4**	**10.7**	**4.3**	**5.3**
Food and beverages, mainly for household consumption	55.2	18.9	9.5	2.7	5.9
Transport equipment, non-industrial	50.6	-34.4	-16.2	-20.4	2.0
Consumer goods, n.e.s.	29.9	16.7	12.2	5.9	5.1
Durables	*35.9*	*18.5*	*11.3*	*19.9*	*6.2*
Semi-durables	*23.7*	*8.2*	*3.4*	*-3.2*	*-2.8*
Non-durables	*32.4*	*22.4*	*19.2*	*6.0*	*10.8*
DUAL USE GOODS	**54.3**	**43.5**	**17.0**	**38.3**	**18.9**
OTHERS	**26.1**	**4.7**	**-6.0**	**1.5**	**2.5**
RETAINED IMPORTS	**28.5**	**17.3**	**9.0**	**7.9**	**7.9**
RE-EXPORTS	**134.5**	**77.6**	**35.3**	**9.3**	**10.3**
GROSS IMPORTS	**31.1**	**19.1**	**10.1**	**8.0**	**8.1**

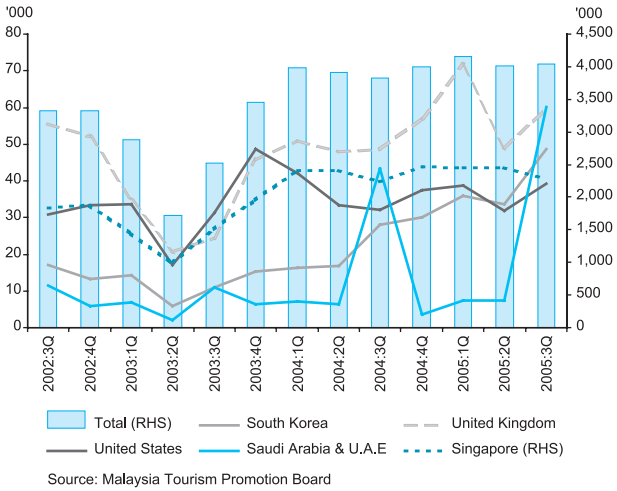
Source: Department of Statistics, Malaysia

equipment. Consonant with sustained private consumer spending, imports of **consumption goods** strengthened further to 5.3%. Consumption imports were supported mainly by higher imports of food and beverages and non-durable consumer goods, namely, medicine, soap and cosmetics.

Tourist arrivals remained high

Tourist arrivals increased at an annual rate of 5.9% to 4 million in the third quarter of 2005. While a significant share of tourist arrivals (74.3%) was attributed to visitors from Singapore, Thailand and Indonesia, aggressive marketing campaigns targeted at summer vacation travel led to a 24.3% increase in tourist arrivals from West Asia. Tourist arrivals from South Asia as well as long-haul tourists from the United States and the United Kingdom were also higher, supported by attractive promotional campaigns and increased connectivity.

Quarterly Tourist Arrivals



Source: Malaysia Tourism Promotion Board

Net inflow of FDI

On a cash basis, both gross inflows and outflows of **foreign direct investment (FDI)** increased to RM20.9 billion and RM20 billion respectively (2Q 2005: RM8.8 billion and RM6.3 billion respectively), reflecting mainly larger short-term inter-company loan transactions, particularly by non-resident controlled oil and gas companies arising from their centralised treasury operations in Malaysia. After adjustments for outflows due mainly to these short-term transactions, FDI recorded a net inflow of RM0.9 billion (2Q 2005: RM2.4 billion). The FDI on cash basis does not include retained earnings and investment in the form of imported machinery and equipment. Of significance, inflows of equity capital were also higher during the quarter. FDIs were channelled mainly into both the upstream and downstream activities of the oil and gas sector, as well as the services and manufacturing sectors. Inflows of FDIs into the services sector were broad-based, channelled particularly into the financing, insurance and business services, as well as restaurants, hotels, wholesale and retail trade sub-sectors.

Overseas investment recorded a significantly lower gross outflow of RM5.4 billion (2Q 2005: -RM21.4 billion) due to a large decline in the short-term loan extensions by non-resident controlled companies arising from the treasury-related operations. Overseas investments during the quarter were led by companies in the manufacturing, services, and agriculture sectors. After adjusting for inflows due to repayment of short-term inter-company loans from abroad, overseas investment recorded a

lower net outflow of RM1.3 billion (2Q 2005: -RM3.1 billion).

During the quarter, **portfolio investment** recorded a net outflow of RM0.2 billion (2Q 2005: +RM3.8 billion). The larger net inflow of portfolio funds in July was attributed partly to the increase in gross inflows arising from the initial reaction of investors towards the Bank's announcement on the adoption of a managed float for the ringgit exchange rate on 21 July 2005. The flows of portfolio funds normalised subsequently amidst an orderly price discovery process.

External debt increased marginally

Malaysia's total external debt increased marginally to RM200.5 billion or USD52.7 billion as at end-September 2005 (2Q 2005: RM197.5 billion or USD52 billion), equivalent to 43.3% of GNP. The **medium and long-term external debt** was lower at RM151.4 billion (2Q 2005: RM154.3 billion), attributed mainly to the net repayment of external debt by the NFPEs. The significantly higher repayment of external debt by the NFPEs was due mainly to the maturity of a US dollar-denominated bond as well as large prepayment of loans. The bulk of the repayments were by companies in the oil and gas, agriculture and telecommunication sectors. The Federal Government registered a small net repayment of RM0.3 billion. Meanwhile, the private sector recorded a net drawdown of external loans of RM1.8 billion (2Q 2005:-RM2.8 billion), reflecting a marginally larger loan drawdown (RM3.2 billion; 2Q 2005: RM2.7 billion) while repayment declined significantly (RM1.4 billion; 2Q 2005: RM5.5 billion).

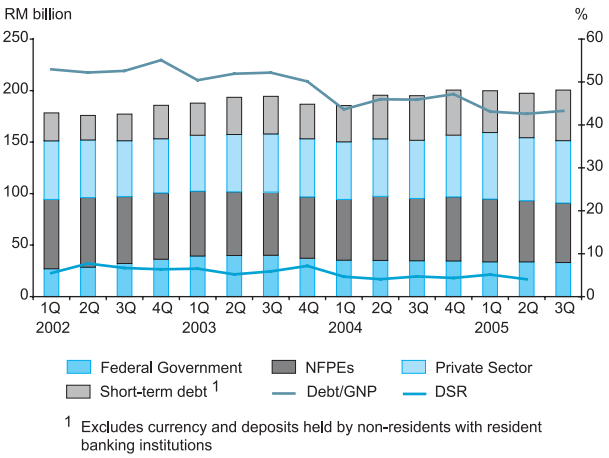
The total **short-term external debt** increased to RM49.1 billion or USD12.9 billion (2Q 2005: RM43.1 billion), due mainly to the increase in short-term debt of the banking sector arising from the hedging activities of banks in relation to trade-related transactions. As at end-September, the short term debt accounted for 24.5% of total external debt and is 16.2% of the net international reserves.

External Debt Outstanding

	2004		2005		
	3Q	4Q	1Q	2Q	3Q[p]
	RM billion				
Medium- & Long-term debt	151.8	156.7	159.3	154.3	151.4
Public sector	95.3	96.7	94.6	93.1	90.8
Private sector	56.5	59.9	64.7	61.2	60.6
Short-term debt [1]	43.3	43.8	40.5	43.1	49.1
Total external debt	195.0	200.5	199.8	197.5	200.5
- USD billion equivalent	51.3	52.8	52.6	52.0	52.7

[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

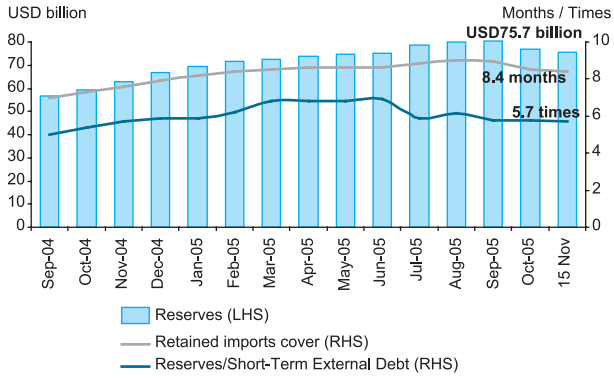


[1] Excludes currency and deposits held by non-residents with resident banking institutions

International reserves

The net international reserves of Bank Negara Malaysia amounted to RM302.7 billion or equivalent to USD80.3 billion as at 30 September 2005. The reserves level has taken into account the quarterly adjustment of the foreign exchange revaluation loss, following the strengthening of ringgit against the major currencies. The reserves amounted to RM285.2 billion or equivalent to USD75.7 billion as at 15 November 2005. The reserves position is sufficient to finance 8.4 months of retained imports and is 5.7 times the short-term external debt.

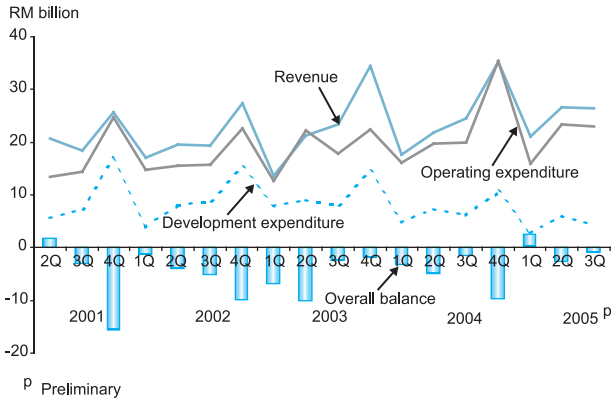
Net International Reserves (as at end-period)



Improved fiscal position - lower fiscal deficit

During the quarter under review, income tax collection was more than sufficient to offset the higher expenditure in petroleum subsidies. As such, the Federal Government recorded a low fiscal deficit of RM805 million or 0.6% of GDP. Revenue performance remained strong in the third quarter of 2005, especially from non-oil sources. Total expenditure rose at an annual rate of 4.5% due to higher operating expenditure as oil subsidy payment continued to rise with higher

Federal Government Finance



p Preliminary

Federal Government Finance p

	2004		2005		
	3Q	Jan-Sept	2Q	3Q	Jan-Sept
	RM billion				
Revenue	24.6	64.1	26.6	26.4	74.1
% growth	*5.5*	*10.2*	*21.9*	*7.3*	*15.6*
Operating expenditure	19.9	55.8	23.4	23.0	62.3
% growth	*11.9*	*5.7*	*18.7*	*15.3*	*11.7*
Current account	**4.6**	**8.3**	**3.2**	**3.4**	**11.8**
% of GDP	***4.0***	***2.5***	***2.7***	***2.6***	***3.2***
Gross development expenditure	6.2	18.4	5.9	4.4	13.1
% growth	*-23.0*	*-26.6*	*-18.3*	*-30.2*	*-28.8*
Loan recoveries	0.1	0.4	0.1	0.2	0.4
Overall balance	**-1.5**	**-9.7**	**-2.7**	**-0.8**	**-0.9**
% of GDP	***-1.3***	***-2.9***	***-2.3***	***-0.6***	***-0.2***
Memo item:					
Total gross expenditure	**26.2**	**74.2**	**29.3**	**27.3**	**75.4**
% growth	*1.0*	*-4.7*	*8.7*	*4.5*	*1.6*
Total Federal Government debt (as at end-period)	204.4	204.4	222.6	227.6	227.6
% of GDP	*45.5*	*45.5*	*45.7*	*46.7*	*46.7*
Domestic debt	169.5	169.5	188.9	194.5	194.5
% of GDP	*37.7*	*37.7*	*38.8*	*39.9*	*39.9*
External debt	34.9	34.9	33.7	33.2	33.2
% of GDP	*7.8*	*7.8*	*6.9*	*6.8*	*6.8*

p Preliminary

international oil prices. In view of the escalating oil prices, the Government raised the prices of retail petroleum products for the third time in the year on 31 July.

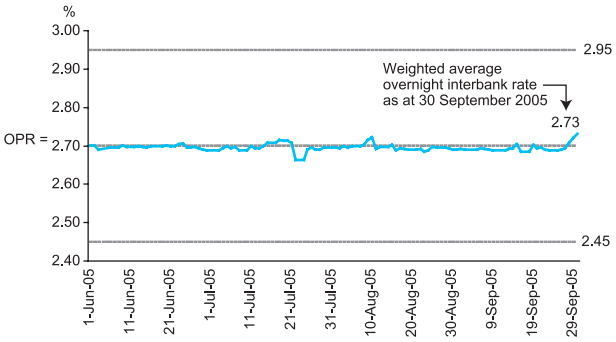
In terms of financing requirements, the ample liquidity in the domestic market allowed funds to be raised entirely from domestic sources. As at end of the third quarter of 2005, the total outstanding debt of the Federal Government amounted to RM227.6 billion or 46.7% of GDP. The external debt of the Federal Government remained low at 6.8% of GDP and accounted for 14.6% of total debt.

MONETARY AND FINANCIAL DEVELOPMENTS

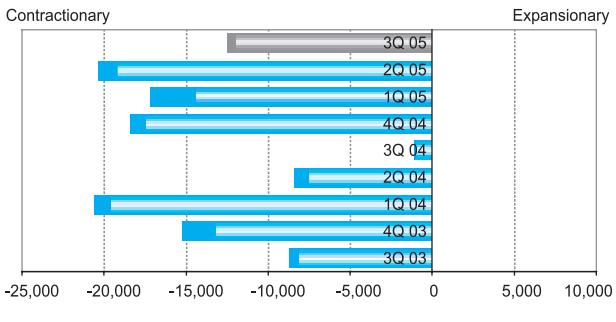
Monetary conditions remained supportive of economic growth

The Overnight Policy Rate (OPR) was maintained at 2.70% during the quarter. The daily weighted average of the overnight interbank rate remained relatively stable, staying within a range of 2.66-2.73%, and averaging 2.70% during the quarter. The 1-month and 3-month interbank rates rose marginally, reflecting expectations of some market participants that interest rates would increase, going forward.

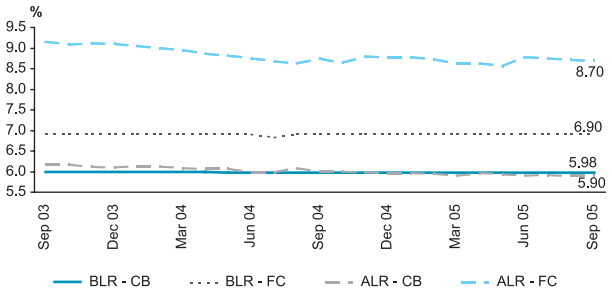
Daily Weighted Average Overnight Interbank Rate



BNM Liquidity Operations
(During the quarter, RM m)



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



Interest Rates

	3Q 04	2Q 05	3Q 05
	At end-period (%)		
Overnight Policy Rate (OPR)*	2.70	2.70	2.70
Interbank rates			
Overnight	2.69	2.70	2.70
1-month	2.79	2.82	2.86
Base lending rates (BLR)			
Commercial banks	5.98	5.98	5.98
Finance companies	6.90	6.90	6.90
Average lending rates			
Commercial banks	6.01	5.90	5.90
Finance companies	8.76	8.78	8.70
Fixed deposit rates			
Commercial banks			
3-month	3.00	3.00	3.00
12-month	3.70	3.70	3.70
Finance companies			
3-month	3.00	3.00	3.00
12-month	3.70	3.70	3.70

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

The average BLRs of commercial banks (CBs) and finance companies (FCs) remained unchanged at 5.98% and 6.90% respectively. Meanwhile, the average lending rate (ALR) of CBs remained unchanged at 5.90%, while the ALR of FCs was lower at

8.70% (June: 8.78%). The latter reflected, to some extent, the lower lending rates charged on new loans by these institutions.

Financing activity remained strong

In the third quarter of 2005, gross financing of the private sector through the banking system and capital market was higher at RM143.3 billion (2Q 2005: RM138.1 billion), increasing at an annual rate of 7.3% (2Q 2005: 8.4%). The increase was attributed mainly to higher loans disbursed by the banking system and to a lesser extent, a larger amount of PDS issuance. On a net basis, banking system loans and PDS outstanding rose at an annual rate of 9.2% at end-3Q 2005 (end-2Q 2005: 8.8%).

On an overall basis, most major loan indicators were higher on an annual and preceding quarter basis.

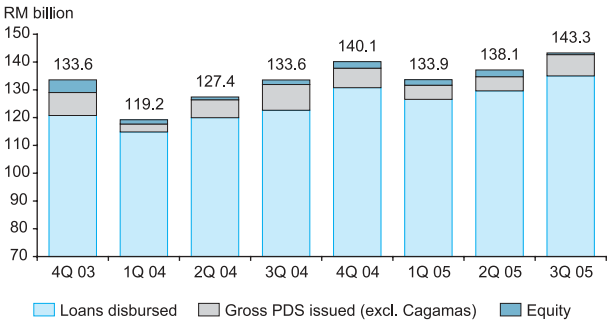
Lending to businesses strengthened during the quarter. Loan approvals and disbursements to businesses expanded at annual rates of 23.7% and 9.5% respectively.

Financing of the Private Sector through Banking System and Capital Market

	During the period (RM billion)				Annual growth (%)		
	2004	Q3 04	Q2 05	Q3 05	2004	Q2 05	Q3 05
Gross total financing	520.3	133.6	138.1	143.3	5.7	8.4	7.3
Loans disbursed*	488.2	122.6	129.6	135.0	10.6	8.1	10.1
Gross PDS (excl. Cagamas)	25.6	9.3	6.1	7.7	-40.2	-5.9	-17.2
Equity	6.5	1.7	2.4	0.6	-16.7	149.2	-62.8
Outstanding total financing (A)+(B)	53.1	14.5	15.0	18.6	8.6	8.8	9.2
Banking system	39.0	11.0	10.2	14.4	7.7	7.6	8.1
Loans outstanding (A)	40.1	9.3	11.0	14.4	8.5	8.3	9.2
Holding of PDS	-1.1	1.7	-0.8	0.0	-3.1	-2.9	-7.6
PDS outstanding (B)	13.0	5.2	4.0	4.2	9.0	10.5	9.4
Memorandum item							
Gross PDS (incl. Cagamas)	36.3	12.7	7.8	9.7	-28.7	4.3	-23.5

* Banking system loans include loans sold to Cagamas.

Gross Private Sector Financing through Banking System and Capital Market



Loans by Sector

	Loans disbursed					Loans out-standing
	During the period				Share of total	Share of total
	2004	3Q 04	2Q 05	3Q 05		
	RM billion				%	
Business enterprises	335.3	83.4	87.8	91.3	67.7	41.3
Large corporations	*234.9*	*58.7*	*60.7*	*62.9*	*46.6*	*24.1*
SMEs	*100.4*	*24.8*	*27.1*	*28.4*	*21.0*	*17.2*
Households	130.3	34.0	35.7	38.0	28.1	53.2
By sector						
Agriculture, hunting, forestry and fishing	13.7	3.5	3.1	4.0	2.9	2.1
Mining and quarrying	2.0	0.4	0.3	0.4	0.3	0.1
Manufacturing	121.5	31.2	32.2	32.1	23.8	11.3
Broad property sector	88.8	22.9	22.4	24.1	17.9	40.8
Construction	*30.3*	*7.6*	*7.4*	*8.0*	*5.9*	*5.5*
Purchase of residential property	*38.8*	*10.4*	*9.4*	*10.1*	*7.5*	*26.5*
Purchase of non-residential property	*12.1*	*3.2*	*3.6*	*3.6*	*2.7*	*6.2*
Real estates	*7.5*	*1.8*	*2.1*	*2.4*	*1.8*	*2.6*
Electricity, gas and water supply	6.4	1.2	2.2	1.6	1.2	0.9
Wholesale, retail, restaurants and hotels	83.7	21.5	24.2	25.6	19.0	8.6
Transport, storage and communication	9.5	1.7	2.2	3.3	2.5	2.1
Finance, insurance and business services	36.5	8.5	7.4	7.4	5.5	5.5
Consumption credit	85.1	22.1	24.9	26.5	19.6	21.5
Of which:						
Credit cards	*36.3*	*9.3*	*10.1*	*11.0*	*8.1*	*2.9*
Purchase of passenger cars	*29.1*	*7.8*	*9.9*	*10.7*	*8.0*	*15.1*
Purchase of securities	12.7	3.2	2.7	2.7	2.0	3.7
Purchase of transport vehicles excluding passenger cars	0.7	0.1	0.1	0.2	0.1	0.5
Others	27.5	6.4	7.8	7.0	5.2	2.9
Total	**488.2**	**122.6**	**129.6**	**135.0**	**100.0**	**100.0**

Source: Bank Negara Malaysia

Loan Indicators

	During the period (RM billion)				Annual Growth (%)			
	2004	3Q 04	2Q 05	3Q 05	2004	3Q 04	2Q 05	3Q 05
Total								
Loan applications	273.3	76.5	80.7	84.0	20.1	21.9	14.6	9.8
Loan approvals	173.6	46.6	47.3	55.6	13.6	16.1	1.6	19.2
Loan disbursements	488.2	122.6	129.6	135.0	10.6	5.8	8.1	10.1
Loan repayments	461.6	118.2	120.6	121.6	7.3	7.5	9.3	2.9
Change in loan outstanding*	40.1	9.3	11.0	14.4	8.5	6.2	8.3	9.2
Of which:								
Business enterprises								
Loan applications	149.9	44.0	42.4	43.1	20.0	29.4	11.7	-2.0
Loan approvals	84.9	22.4	21.7	27.7	9.8	10.1	-8.0	23.7
Loan disbursements	335.3	83.4	87.8	91.3	10.5	5.0	6.0	9.5
Loan repayments	319.8	83.7	84.7	84.7	6.8	8.7	11.5	1.2
Change in loan outstanding*	5.5	-0.4	2.6	4.9	2.6	-0.2	1.4	3.9
SMEs								
Loan applications	54.2	15.2	16.4	17.3	21.7	25.4	12.9	13.9
Loan approvals	31.6	8.8	9.0	11.0	22.0	33.5	7.2	25.8
Loan disbursements	100.4	24.8	27.1	28.4	15.3	12.8	9.2	14.7
Change in loan outstanding*	6.3	2.2	2.0	3.0	7.7	8.1	9.1	9.8
Large corporations								
Loan applications	95.7	28.8	26.0	25.8	19.1	31.6	10.9	-10.4
Loan approvals	53.3	13.7	12.7	16.7	3.7	-1.0	-16.4	22.4
Loan disbursements	234.9	58.7	60.7	62.9	8.6	2.1	4.7	7.3
Change in loan outstanding*	-0.8	-2.6	0.6	1.8	-0.6	-4.9	-3.3	0.0
Households								
Loan applications	120.2	31.5	37.2	38.9	22.1	12.3	15.3	23.6
Loan approvals	86.8	23.4	25.3	26.5	20.5	21.8	11.2	13.2
Loan disbursements	130.3	34.0	35.7	38.0	13.9	11.2	13.4	11.6
Loan repayments	107.0	26.7	28.1	29.1	13.7	12.3	9.8	8.8
Change in loan outstanding*	33.3	10.4	9.2	11.3	14.4	14.2	15.2	14.9

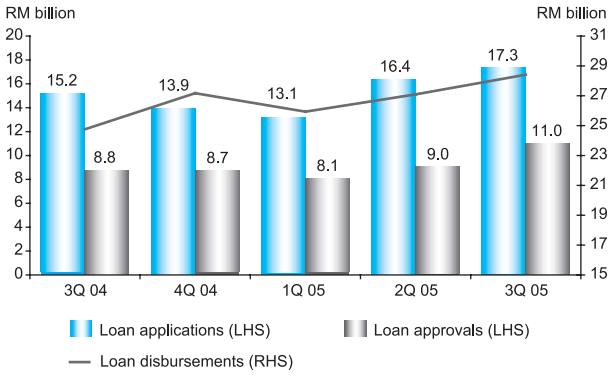
* The annual growth is for end-period.
Source: Bank Negara Malaysia

The increase in loan disbursements to the business sectors, on an annual basis and compared to the preceding quarter, was particularly evident in the wholesale and retail trade, restaurants and hotels; and transport, storage and communications sectors. In terms of share, loans to businesses during the quarter continued to be disbursed mainly to the manufacturing (35.2% of total disbursements to businesses); wholesale and retail trade, restaurants and hotels (28%); construction (8.7%); and finance, insurance and business services (8.1%) sectors. Loan applications also increased quarter-on-quarter, but declined on an annual basis, due to a high base effect arising from a marked increase in the amount of applications by large corporations in 3Q 2004.

In terms of lending to the small and medium enterprises (SMEs), loan applications and approvals increased at annual rates of 13.9% and 25.8% respectively. A total of RM11 billion was approved for 24,715 SME accounts during the quarter (2Q 2005: RM9 billion approved for 21,421 SME accounts). Disbursements to the SMEs were also higher during the quarter.

With loans outstanding to SMEs growing at a faster pace of 9.8% and a pick up in loans outstanding to large corporations, loans outstanding to the business sector as a whole increased at a stronger annual rate of 3.9% at end-September. Meanwhile, the gross NPL ratio of business loans continued to decline (11.5% at end-3Q 2005; 12.3% at end-2Q 2005).

Bank Lending to SMEs

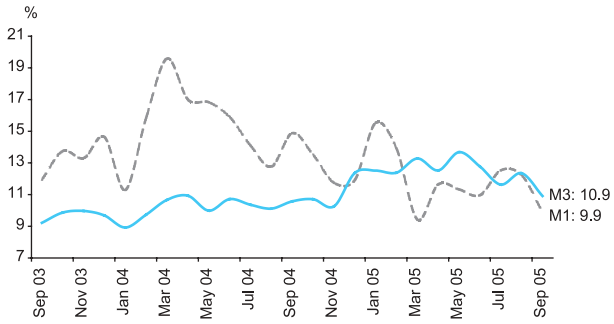


In the household sector, lending remained resilient. Loan applications and approvals grew by 23.6% and 13.2% respectively on an annual basis. Loan disbursements to households, which increased at an annual rate of 11.6%, were driven mainly by credit card spending (29% of total disbursements to households), purchase of passenger cars (28.3%) and purchase of residential properties (26.7%). The growth in household loans outstanding remained relatively stable at 14.9% at end-3Q 2005 (end-2Q 2005: 15.2%). Similarly, the gross NPL ratio of household loans remained relatively stable at 7.4%.

Monetary aggregates continued to expand at sustained growth rates

Narrow money, M1, increased at an annual rate of 9.9% at end-3Q 2005 (2Q 2005: 11%), while, broad money, M3, expanded at an annual rate of 10.9% at end-3Q 2005 (2Q 2005: 12.8%). The main impetus for the expansion in broad money during the quarter was the higher loans extended to the private sector by the banking system, in line with higher domestic economic activity. However, net claims on the Government were contractionary on M3, as the Government deposited the proceeds from the issues of

Monetary Aggregates: Annual Change



M3 Determinants

	Change during the period			
	Yearly	Quarterly		
	2004	3Q 04	2Q 05	3Q 05
	RM billion			
M3	68.0	13.6	8.3	4.3
Net claims on Government	-15.9	-2.7	-4.7	-4.3
Claims on private sector	30.3	10.3	7.3	14.7
Net external operations *	82.0	12.0	12.9	-1.5
Other influences	-28.3	-6.1	-7.2	-4.5

* Pre-revaluation

Malaysian Government Securities (MGS) with Bank Negara Malaysia. In addition, net external operations were also marginally contractionary on M3 due to lower net external assets of the banking system.

Higher net funds raised from the capital market

The capital market continued to play an important role in financing the economy during the third quarter of 2005, mobilising net funds of RM10.9 billion (2Q 2005: RM7.6 billion), attributable largely to the higher amount of funds raised from the bond market.

In the private debt securities (PDS) market, gross financing increased by 24.3% on a quarterly basis to RM9.7 billion (2Q 2005: RM7.8 billion). The higher amount of funds raised were supported by prevailing low yields for medium- to long-term bonds. New PDS were issued by 21 corporations mainly from the construction, finance, real estate and business services sectors. Of the total funds mobilised, a substantial share (57.8% of total) was channeled to finance new economic activity, while funds raised to refinance existing debt accounted for 17.2% of the total. During the quarter, Cagamas MBS Berhad issued its second series of residential mortgaged-backed securities, accounting for 22% of total issuances in the quarter. After adjusting for redemptions, net funds raised through the PDS market was higher at RM4.1 billion (2Q 2005: RM3.7 billion).

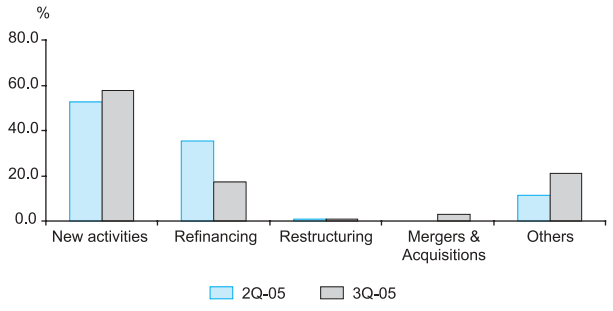
Conversely, funds raised through the equity market were lower, amounting to RM621.8 million (2Q 2005: RM2.4 billion), although a higher number of smaller-sized companies accessed the equity market for financing. Initial public offerings (IPOs) undertaken during the quarter were lower in value despite the higher number of IPOs issued during the period, compared to the previous quarter (3Q 2005: 25 IPOs; 2Q 2005: 14 IPOs). 16 IPOs were listed on the MESDAQ market, five on the Second Board and four on the Main Board.

Funds Raised in the Capital Market

	2004		2005		
	3Q	4Q	1Q	2Q	3Q
	RM million				
By Public Sector					
Government Securities, *gross*	10,389	7,021	4,000	9,543	8,233
Less Redemptions	2,000	1,000	-	8,500	2,450
Less Government holdings	-	-	-	-	-
Equals Net Federal receipts	8,389	6,021	4,000	1,043	5,783
Khazanah Bonds, *net*	(198)	-	833	-	-
Govt. Investment Issues, *net*	740	1,243	2,000	-	-
Merdeka Savings Bond, *net*	495	436	357	378	383
Net Funds Raised	9,426	7,700	7,190	1,421	6,166
By Private Sector					
Shares	1,663	2,316	2,009	2,412	622
Debt securities	12,718	10,083	5,486	7,823	9,726
Private Debt Securities (PDS)	9,268	9,483	5,286	6,843	9,726
Cagamas	3,450	600	200	980	-
Less Redemptions	6,865	4,463	4,212	4,078	5,627
Net Issues	5,853	5,620	1,274	3,745	4,099
Net issues (excluding Cagamas)	2,403	5,494	2,634	3,380	6,359
Net Funds Raised	7,516	7,936	3,282	6,158	4,721
Total Net Funds Raised	16,942	15,636	10,473	7,579	10,887
Short-term Papers and Notes, *net* [1]	(623)	(1,103)	587	82	570
Total	16,319	14,533	11,059	7,661	11,457

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

Private Debt Securities Issued by Purpose
(% of total)

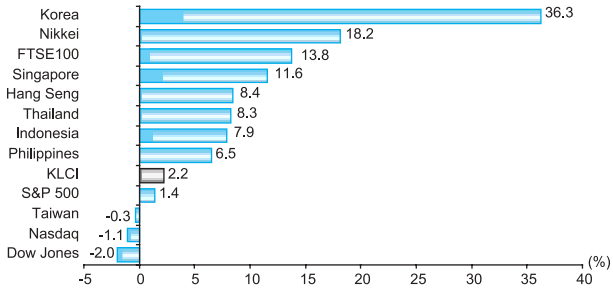


The Government made four issuances of Malaysian Government Securities (MGS), raising gross funds of RM8.2 billion during the quarter. Of significance was the inaugural issuance of a 20-year MGS of RM1 billion on 15 July as part of the Government's efforts to lengthen the benchmark yield curve. On a net basis, the public sector raised RM6.2 billion (2Q 2005: RM1.4 billion).

Improved KLCI performance in the third quarter

Buying interests on several index-linked stocks early in the third quarter of 2005 was encumbered by continued concerns over high global oil prices and increasing domestic inflation. Nevertheless, market performance turned positive in September, with the anticipation of a favourable 2006 Budget. During the quarter, the performance of the KLCI improved by 39.22 points

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



Bursa Malaysia: Selected Market Indicators

	As at end				
	2004		2005		
	3Q	4Q	1Q	2Q	3Q
Price Indices					
- Composite	849.96	907.43	871.35	888.32	927.54
- EMAS	202.35	214.26	204.98	203.73	211.02
- Second Board	108.95	110.87	101.76	87.79	87.48
Average daily turnover					
- Volume (million units)	338.93	441.36	517.97	416.52	423.20
- Value (RM million)	681.55	835.02	965.78	651.99	687.48
Market Capitalisation (RM b)	672.64	722.04	694.89	688.63	715.36
No. of Companies Listed	945	962	982	990	1,007

Source: Bursa Malaysia

Bursa Malaysia: Turnover of Corporate Securities

	2004				2005					
	3Q		4Q		1Q		2Q		3Q	
	million units	RM million	million units	RM million	million units	RM million	million units	RM million	million units	RM million
Turnover	22,031	42,852	27,364	51,771	30,042	56,261	25,824	40,423	27,931	45,374
of which:										
Main Board	15,494	36,763	20,186	45,129	21,236	48,384	18,253	35,778	20,538	40,892
of which										
- Consumer Products	1,154	3,149	899	2,924	1,018	3,117	872	2,072	1,156	3,146
- Industrial Products	2,031	2,719	4,036	4,978	4,829	5,767	2,996	3,076	2,692	3,281
- Construction	1,096	1,706	1,070	1,922	1,579	3,114	810	1,287	1,057	1,648
- Trading/Services	4,296	13,729	5,500	16,991	4,320	15,710	4,055	14,160	4,312	16,954
- Finance	2,008	7,838	1,958	8,090	3,059	10,495	2,173	8,253	2,614	9,199
- Properties	2,230	3,560	3,205	5,468	3,367	5,602	3,767	3,069	2,123	1,665
- Plantations	383	2,127	771	2,171	604	2,168	453	1,951	547	2,266
- Mining	0	4	-	1	0	1	0	7	0	1
Second Board	4,014	4,130	4,227	4,102	5,537	5,586	4,194	2,960	3,722	2,568

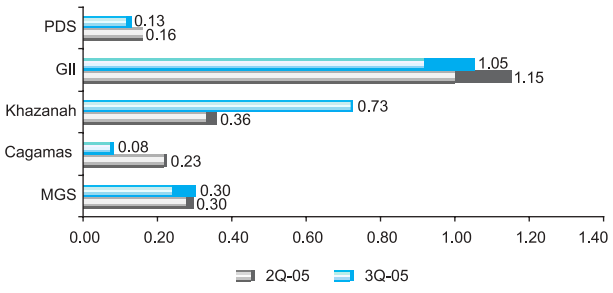
Source: Bursa Malaysia

(2Q 2005: +16.97 points), ending the quarter higher at 927.54 (2Q 2005: 888.32). Market capitalisation recorded a higher level at RM715 billion (2Q 2005: RM688.6 billion). In addition, trading activity increased as a higher average daily turnover of 423 million units was recorded during the quarter (2Q 2005: 417 million units).

Lower secondary trading in the bond market

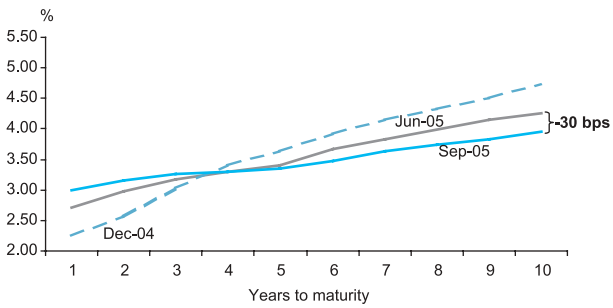
Trading activity in the secondary market declined slightly to RM92.2 billion in the third quarter of 2005 (2Q 2005: RM94.5 billion). MGS contributed 53.4% of total trading activity, while the Government Investment Issues (GII) accounted for 12.6% of the total trade. In terms of liquidity, the GII and Khazanah bonds were the most liquid papers, registering liquidity ratios of 1.05 and 0.73 respectively.

Liquidity Ratio: Turnover / Outstanding



A flatter MGS benchmark yields curve was experienced in the third quarter of 2005. The 3-year MGS yield rose by 9 basis points while the 10-year MGS yield declined by 30 basis points. The shorter-end of the benchmark yields curve was plagued by concerns of higher inflation and the decline in interest by non-resident investors. On the other hand, despite the higher issuance of bonds in the third quarter of 2005, continued high demand by domestic institutional investors pushed the longer-end of the benchmark yields curve lower. In addition, the decline of long-term yields was also due to concerns over the impact of high crude oil prices on global economic growth.

Trend in MGS Yield



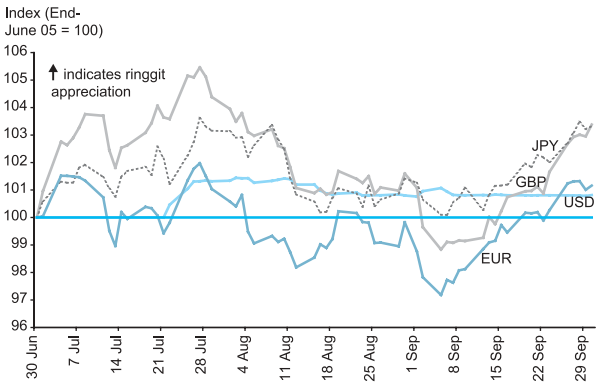
Performance of the ringgit

On 21 July, the ringgit peg to the US dollar was replaced with a managed float system. The ringgit is now monitored against a trade-weighted basket of currencies. The primary motivation for the policy shift was to better position Malaysia to respond and benefit from the structural changes occurring in the region and in the international environment.

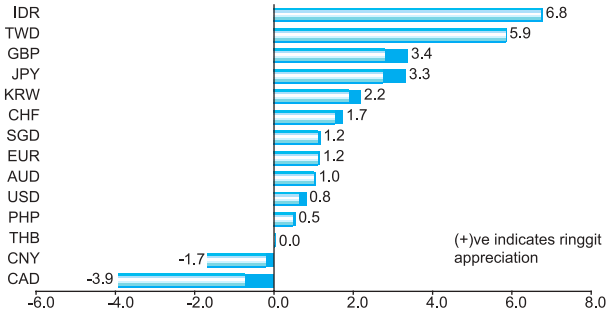
Prior to the unpegging, the ringgit moved with the US dollar, appreciating by 11.9%, 10.4% and 9.7% against the euro, pound sterling and Japanese yen respectively during the period between 1 January - 21 July

2005. The US dollar had strengthened amidst better US economic growth prospects relative to the Euro Area and Japan, as well as market expectations of further increases in US interest rates. Over the same period, the ringgit also appreciated within a range of 0.2% - 7.7% against regional countries, the exception being a depreciation against the Philippine peso (0.6%). Regional currencies depreciated amidst market concerns over high oil prices adversely affecting regional economies.

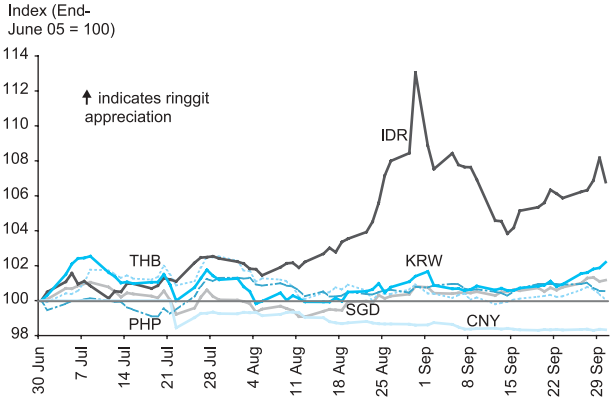
Ringgit Performance Against Major Currencies



Summary of Ringgit Performance Against Selected Currencies
Percent Change (1 July - 30 September 2005)



Ringgit Performance Against Regional Currencies



Performance of Ringgit Against Selected Currencies

RM per foreign currency	As at end							% change since *					
	30 Jun 97	02 Sep 98	3Q 04	4Q 04	1Q 05	2Q 05	3Q 05	30 Jun 97	02 Sep 98	3Q 04	4Q 04	1Q 05	2Q 05
US dollar	2.5235	3.8000	3.8000	3.8000	3.8000	3.8000	3.7692	-33.0	0.8	0.8	0.8	0.8	0.8
Euro	-	-	4.6826	5.1729	4.9125	4.5948	4.5421	-	-	3.1	13.9	8.2	1.2
Pound sterling	4.1989	6.3708	6.8347	7.3169	7.1415	6.8685	6.6438	-36.8	-4.1	2.9	10.1	7.5	3.4
100 Japanese yen	2.2088	2.7742	3.4264	3.7026	3.5446	3.4469	3.3359	-33.8	-16.8	2.7	11.0	6.3	3.3
Singapore dollar	1.7647	2.1998	2.2475	2.3258	2.3034	2.2576	2.2315	-20.9	-1.4	0.7	4.2	3.2	1.2
100 Thai baht	9.7470	9.3713	9.1644	9.7636	9.7013	9.2032	9.1988	6.0	1.9	-0.4	6.1	5.5	0.0
100 Philippine peso	9.5878	8.8302	6.7517	6.7706	6.9381	6.7628	6.7262	42.5	31.3	0.4	0.7	3.2	0.5
100 Indonesian rupiah	0.1038	0.0354	0.0414	0.0408	0.0401	0.0391	0.0366	183.4	-3.3	13.2	11.5	9.4	6.8
100 Korean won	0.2842	0.2827	0.3295	0.3671	0.3734	0.3699	0.3619	-21.5	-21.9	-9.0	1.4	3.2	2.2
Chinese renmimbi	0.3045	0.4594	0.4591	0.4591	0.4591	0.4591	0.4669	-34.8	-1.6	-1.7	-1.7	-1.7	-1.7

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

In the period following the move to a managed float to the remaining part of the third quarter of 2005 (22 July - 30 September 2005), the ringgit appreciated against the major and regional currencies. The initial ringgit appreciation against the US dollar following the policy adjustment was however moderated by market expectations for further US interest rate increases, which would result in widening yield differentials in favour of the US dollar. The euro depreciated amidst uncertainty over the outcome of Germany's elections, while the yen also depreciated amidst market concerns over the impact of high oil prices on the Japanese economy. Regional currencies continued to be adversely affected by market concerns over the impact of high oil prices on import costs and global demand for regional exports, as well as the net sale of equities from some regional economies by foreign investors. The Indonesian rupiah depreciated significantly in the latter part of August on dollar demand for oil imports and market concerns over the impact of high oil prices on government fuel subsidies.

DEVELOPMENTS IN THE BANKING SYSTEM

The financial position of the banking system remained strong in the third quarter of 2005. The high capital position amidst favourable financial performance and improved asset quality enabled the banking system to continue to support economic growth through expanded lending activities.

Strong capital position

The capital position of the banking system remained high during the quarter. As at end-September 2005, the risk-weighted capital ratio (RWCR) and the core capital ratio (CCR) stood at 13.3% and 10.6% respectively. The decline in RWCR and CCR was attributable to the stronger growth in the risk-weighted assets (+2.8%), driven primarily by market risk charges and higher lending activities by the banking system.

Capital Position Remained Strong

	2004				2005		
	1Q	2Q	3Q	4Q	1Q	2Q	3Q
Capital							
CCR (%)	11.0	11.7	11.4	11.3	10.9	10.8	10.6
RWCR (%)	13.7	14.3	13.9	14.3	13.8	13.6	13.3

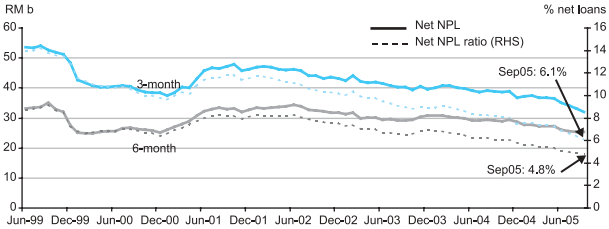
Profitability remained favourable

The banking system recorded pre-tax profits of RM9.1 billion for the period up to 30 September 2005, 2.1% higher compared to the corresponding period in 2004. This was largely on account of higher income from interest-related and fee-based activities as well as trading and investment activities. The annualised return on average assets and equity of the banking system stood at 1.3% and 16.3% respectively.

Continued improvements in asset quality

The quality of banking system assets continued to improve, with net non-performing loans (NPLs) based on 6-month and 3-month classifications declined to RM25.5 billion (-2.1%) and RM32 billion (-6.9%) respectively. The improvement was underpinned by higher recoveries and reclassification of NPLs to performing accounts. With the decline, the net NPL ratios improved further to 4.8% based on 6-month classification (2Q 2005: 5.1%), and 6.1% based on 3-month classification (2Q 2005: 6.7%).

Banking system: Non-performing loans



Public-Private Dialogue Session of the 7th SEACEN Conference of Directors of Supervision of Asia Pacific Economies 4 August 2005, Kuala Lumpur

"Cross-Border Challenges in Implementing Basel II in Emerging Economies"

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

In most emerging markets, the banking sector forms the key component of the financial system that drives the economy. In Malaysia, despite the increased significance of the domestic capital market, the banking sector continues to be the predominant source of financing in our financial system, as it evolves to offer more innovative financial solutions to meet the more sophisticated needs of customers and investors. The increasingly complex nature of their operations have had a significant impact on their risk profile over the years. The domestic financial environment has also become more competitive, following an intensification of the liberalisation and deregulation process. Domestic banking institutions have now also ventured beyond our domestic borders. Increasingly, supervisory attention is therefore directed towards ensuring that a robust risk management framework is put in place to support such business expansion and growth strategies.

Against this background, the call for improvements in risk management through the adoption of Basel II and the discussions on the effectiveness of supervisory arrangements on cross-border banking and financial activities are most relevant. The incidence involving case of the BCCI in the early 90's as well as that of and Baring in the mid-90's have also brought to the fore weaknesses the gaps in supervisory oversight activities and highlighted the need for greater cooperation between home and host supervisors. Similarly, the arrangements for cross- border activities involving either international branch networks or the operation of subsidiaries have been discussed widelyis a subject of much discussion within supervisory circles, particularly with respect to its implications on supervisory cooperation. While there may be differences in the operational arrangements and in the nature of activities undertaken by global players in emerging markets within in Asian and Latin America regions, the significance of their presence in the financial systems in both regions makes this dialogue session most relevant and timely. In Malaysia, foreign banks' account for almost 30% of the total assets of the banking industry. In the context of cross-border banking, the local incorporation of all foreign-owned banking

institutions' branches in 1994 has contributed towards the strengthening of Bank Negara Malaysia's supervisory oversight over the activities of foreign-owned banking institutions in Malaysia. The capital and resources dedicated to support the domestic subsidiary operations reflects the commitment of the foreign-owned banking institutions in the future prospect of the country. In addition, it has also made easier facilitated the assessment of the financial soundness of local operations of foreign banks. While the merits of different operational arrangements are still a matter of much debatedebateable, particularly in terms of business flexibility, the subsidiary structure of foreign-owned banking institutions in Malaysia has allowed forfacilitated the consistent application of rules and regulations by Bank Negara Malaysia to the entire banking system.

The increasing significance of the foreign institutions, along with the different operational structures were key factors that influenced the design of the early cross-border supervisory framework. This is detailed in the Basel Concordat, that outlined the principles for supervision of foreign banks by home and host authorities, issued by the Basel Committee of Banking Supervisors (BCBS) in 1983. The concordat recognised the greater roles of host supervisors for supervising foreign banks that operate via locally-incorporated subsidiaries., Some home country supervisory in fact referred to the host supervisor as the banks' 'intermediate home supervisor'.

The framework also recommended a high level of reliance by host supervisory on the works undertaken by the home supervisors in their oversight and monitoring of the soundness of the foreign banks' branches in their jurisdictions. These important principles have become the foundations for the current cross- border supervisory framework and have been the basis for the formulation of the High- Level Principles for the Cross-Broader Implementation of the New Accord issued in 2003. The high level principles Principles have sought to further reinforce the responsibilities of home supervisors in conducting consolidated supervision of financial conglomerates and the greater expectation on host supervisors in the supervision of individual subsidiary banks in their country.

The new capital accord is yet another significant development that would challenge the robustness of the cross- border banking framework and principles. The real test would be in translating the principles into detailed policies and action plans that are both sound and practicable. The main challenge in applying the new accord uniformly across the globe is, indeed the complexity of the framework itself. While the underlying intention of the framework to promote sound risk management and best practices is not in question, noble countries, particularly the emerging markets, are at different levels of readiness to cope with the extensive changes required and potential implications of Basel II. With significantlyGiven the different level stages of development and levels of market sophistication, applying Basel II, that is designed fundamentally based on parameters and experiences drawn from developed economies, may not be appropriate without

some customisation to better reflect the situation in the emerging markets. The low liquidity in some markets and the higher level of market volatility in most emerging markets may not be adequately captured in the underlying assumptions within the Basel II framework. It is therefore important to emphasise that such constraints and the need for some customisation must be well understood and acknowledged by foreign banks operating in emerging markets. In essence, the discussions on the cross-border implementation of Basel II will contribute towards avoiding the imposition of 'one size fits all' solutions, and minimising the potential adverse implications of the differences in approaches in addition to avoiding the unnecessary duplication of efforts and investments.

In many emerging economies, Basel II is seen as an important catalyst to accelerate the introduction of best risk management practices within the banking sector in the medium and longer term. While best practices that have been adopted by global banks have even surpassed the expectations of Basel II, this is not the case for most domestic institutions. In many emerging markets where the banking system is still highly fragmented, promoting the adoption of these practices throughout the entire industry will indeed be a challenge. Such efforts would therefore need to be implemented within the agenda of the overall financial sector development programme in the individual countries. It is within this context that Malaysia has chosen to adopt a flexible timeframe, underpinned by four key implementation principles:

First, for capacity building measures to be implemented;

Second, within these capacity building efforts, the emphasis on the enhancement of the risk management framework for all banking institutions;

Third, to emphasise on strong business justification instead of regulatory mandate in the adoption of the more advanced approaches; and

Finally, to enhance the supervisory methodology to assess the internal models and the advancedd risk management systems.

The rigorousness of the analytical process under Basel II will certainly be demanding for banking institutions. It is equally demanding from the supervisory perspective to develop an appropriate response and assessment framework on these processes. Instead of over focus on validating the detailed quantitative and statistical procedures, supervisory attention should would need to ensure that the analytical processes are undertaken to support decision making, and not merely to meet regulatory expectations. Supervisors also should need to undergo early training to identify the relevant issues when undertaking the supervisory assessment. This underscores, the importance of efforts to accelerate supervisory capacity building efforts, particularly in the development of specialised supervisory skills to conduct model validation. underestimatedWhile emerging market economies may have different timelines and prioritypriorities, rigorous training programmes need to be

simultaneously pursued to ensure that the supervisors are able to fully understand well and interpret the qualitative materials, yet and at the same time, are able to comprehend the broader supervisory issues and concerns.

The benefits of Basel II cannot be fully realised if emerging countries do not have the necessary foundation for effective implementation. In reality, many some developing and emerging countries still need to develop a more efficient and comprehensive legal, accounting, regulatory and market infrastructure. The challenge for the emerging economies is therefore to place high priorities towards establishing and strengthening these fundamental infrastructures. Without the proper foundations in place, the countries are not only creating athis could pose impediments to the implementation of Basel II, in addition tobut also inhibiting inhibiting the proper implementation of cross- border regulations and the effective conduct of consolidated supervision.

In emerging countries where the necessary infrastructures are is already in place, supervisors need to look beyond the state of the current financial landscape, in the context of the globalisation of financial services, and integration into with the international landscape. Against such this backdrop, the appropriate regulatory framework for the banking industry, in particular, the future of cross-border supervisory arrangements, needs to be articulated. In this regard, let us not forgetit is also important to recognise that the challenge of cross-border banking in the context of the increased significance of international banks is has far wider implications.

The effectiveness of cross border arrangements would be easier to achieve when there is a greater consistency in the regulatory rules and standards as well as supervisory practices among the home and host supervisors. The new capital accord was therefore intended to accelerate the convergence process with respect to the adoption of international standards for capital adequacy in the global environment. In reality, however, total convergence cannot be expected given the varying levels of sophistication between developed and emerging countries. At any point in time, differences in rules and standards can be expected to exist. Our main task will be to find areas where convergence can be accelerated. There may also be room for greater mutual recognition of supervisory assessments among fellow supervisors that could avoid duplicating duplication of efforts and resources and efforts that could contribute towards reducing compliance costs to the banking institutions.

While we deliberate on the complex issues relating to cross- border implementation of Basel II, supervisors and banking institutions operating in emerging markets also need to take into account the broader implications of Basel II on the economy as well as the access to financing for specific economic sub-sectors, such as the small and medium size enterprises (SMEs) during economic downturn. The highly risk sensitive framework could indeed have a potential adverse impact on bank

lending behaviour. There has to be continuing discussion between supervisors and the banking institutions on the broader supervisory issues and the effectiveness of regulatory and supervisory framework that could mitigate such potential adverse implications. Basel II is only one component of prudential regulation, and hence must not be viewed in isolation. In this context, the suitability of other rules such as the provisioning framework and the stress testing practices must also be discussed with a view for future enhancements.

While we engage ourselves in the intricacies of implementing Basel II we should not loose sight of the ultimate objective of maintaining financial stability. This dialogue is most important in providing a forum for the exchange of views and the sharing of experiences. Indeed, the outcome of the discussions should be escalated to a higher level of policy deliberation so as to further accelerate the progress in detailing the issues relating to the cross-border implementation of Basel II.

2005 Dialogue Session with Insurers and Takaful Operators
9 August 2005, Kuala Lumpur

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

The Malaysian economic and financial landscape continues to be dramatically transformed. As this transition process gains momentum, the key issues confronting the insurance and takaful industries today are: defining effective growth strategies in an increasingly borderless world; sustaining confidence in the face of increased demands for greater transparency; responding to the challenges of regulatory and accounting changes; and managing risk in an increasingly complex and volatile environment. These challenges have spawned multi-faceted reforms, involving changes in business models, risk orientations, operating practices and in the interface with customers. It is this modernisation process of the insurance and takaful industries that will take it to new heights, bringing with it widespread and far reaching implications on the overall financial system and the economy.

It is my pleasure to welcome you to this year's dialogue session between Bank Negara Malaysia and the insurance and takaful industries to discuss these issues in greater depth within our domestic context, and to consider the necessary actions that need to be taken under increasingly more challenging conditions. The theme for this year's dialogue: "Moving Towards a More Competitive Market", will focus on the challenges of pricing deregulation, product transparency, operating cost efficiencies and commission disclosures. The issues revolving around operating practices and the interface with customers also needs to be viewed in terms of the broader dimensions of public confidence, transparency and risk management.

The dialogue this year is also based on a new format focused on issues with long-term strategic implications that need to be addressed in the current environment. It is designed to encourage deliberations from the different perspectives between industry participants and Bank Negara Malaysia. The dialogue will also serve as a platform to reflect on recent economic and financial developments and the major policy initiatives by Bank Negara Malaysia. Allow me to take this opportunity to share some thoughts with you in these areas.

The outlook for the Malaysian economy continues to remain favourable, despite some signs of moderating growth in the global economy arising from the higher oil prices. Malaysia has had a track record of solid and steady growth for a number of years now. The diversified economic structure and sound macroeconomic fundamentals have been important in supporting this trend. Of importance is that this growth is private sector

driven. While price pressures have been contained by improvements in labour productivity and capacity expansion, domestic inflation has begun to edge upwards, largely due to cost-related factors. In balancing these trends, monetary policy has continued to remain supportive of growth. Growth in Asia has also remained strong with mutually reinforcing effects for regional economies, including Malaysia, as regional integration continues to intensify.

The global environment, however, is clouded by uncertainties amid the persistence of global imbalances. The United States continues to record large deficits in its external accounts. There is significant discussion in the global community on how these imbalances may be unwound. The consensus, however, is clear that the adjustment should be orderly. There has however, been an over focus on realignment of exchange rates to facilitate this adjustment. But this may risk destabilizing adjustments. Ultimately, the structural imbalances have to be addressed by some combination of adjustments in demand, prices and exchange rates. In particular, the rebalancing of global growth can be expected to be a major factor contributing to an orderly adjustment to these imbalances. Indeed, it would require more than just adjustments in exchange rates. The nature and breadth of the adjustments will be important to achieve a long-term solution.

With its young workforce, growing productivity, competitive and dynamic economies, there is great potential for the Asian economies to contribute towards the re-balancing of global growth. With rising income levels in regional economies, particularly among the growing middle-income group in China, India and the ASEAN economies, there is potential for an expansion of demand within the region. The rebalancing of global growth across the world will eventually contribute towards reducing the prevailing imbalances. Malaysia's own agility to absorb and respond to the external and domestic challenges has allowed us to efficiently shift resources to new areas of growth, to new areas of comparative advantage and thus, sustain our long-term prospects. Going forward, Malaysia's economic policy will therefore continue to focus on ensuring that the economy's flexibility and resilience is sustained.

With the strengthening of the economy, the financial system and our fundamentals, the opportunity has been taken to deregulate and liberalise the environment further. The most recent policy initiative in this direction has been the shift in the exchange rate regime to a managed float. Under this regime, exchange rate stability will continue to be a primary objective of exchange rate policy. Malaysia is a trading economy that is highly integrated with the world economy, and in this context, a stable exchange rate environment continues to be important. With changes in the international economic and financial environment, the move towards a managed float was important to enable Malaysia to maintain a stable exchange rate against its major trading partners. Under this arrangement, Bank Negara Malaysia will now monitor the exchange rate against a currency basket to ensure it remains close to fair value. The transition to the new system has been

orderly, with transactions mainly reflecting trade and foreign direct investment as well as portfolio investment activities.

As providers of long-term capital and efficient risk transfer solutions for productive economic activity, the insurance and takaful sectors play an important role in supporting the economic transformation process. Over the years, that role has increased in prominence with the impressive growth achieved by the industry. In 2005, the insurance and takaful industries have continued to demonstrate resilience and strong performance despite challenging investment and underwriting conditions. Premiums and contributions have continued to expand at double-digit growth rates in the first half of 2005, with the general sector rebounding strongly after two consecutive years of slow growth. The underlying fundamentals for sustainable growth has also strengthened with stronger solvency positions reported by the majority of players, continued profitability and improved underwriting discipline.

The growth has also been accompanied by enhancements to the competitive structure, improvements in innovation and a greater degree of differentiation in the market, offering consumers a wider range of products and services. In particular, the advent of bancassurance and bancatakaful has seen more players packaging life insurance and family takaful with innovative investment options that incorporate banking product features. Today, bancassurance and bancatakaful constitutes a significant feature of Malaysia's financial landscape, and continues to develop rapidly in terms of market reach and operational sophistication.

The recent passage of the Insurance (Amendment) Bill on Financial Advisers marks yet another important milestone in ongoing efforts to achieve a more diversified market structure. With the legislative framework now in place, I am pleased to announce that Bank Negara Malaysia will soon be issuing licences for financial advisers. The introduction of financial advisers in the Malaysian insurance industry will further diversify the distribution system for life insurance. Corporate bodies with a minimum paid-up capital of RM100,000 will be eligible to apply for a financial adviser's licence. Similar amendments to the Takaful Act 1984 will be undertaken in the near future within the context of more substantive and wide-ranging changes to the current legislation.

Our foundations for financial stability will also continue to be strengthened with the ongoing evolution of a more diversified and balanced financial structure. Today, Malaysia stands at the forefront in the provision of comprehensive Islamic financial services covering banking, takaful, and the capital and money markets. In the area of takaful, Bank Negara Malaysia continues to undertake initiatives aimed at developing significant market players that are able to compete effectively and efficiently.

Although the organic growth of the existing takaful operators may meet the current demand for takaful products and services, it is envisaged that players with strong capabilities in operational and risk

management, and product development would hasten the further expansion of the takaful industry. In May this year, the Bank announced the issuance of up to four new licences for takaful operators. The additional takaful licences are offered to sound financial institutions, with priority accorded to those with experience in Islamic banking, takaful or insurance business. It could also include joint ventures or consortiums of financial institutions, which includes at least a banking group. Such joint ventures or consortiums would enable the new takaful operators to leverage on the expertise, experience and infrastructure of their partner financial institutions. In line with the liberalisation in the Islamic banking industry, foreign equity interest of up to 49% will be allowed in the takaful entity to secure strong shareholders, and foster meaningful strategic alliances.

For insurers, the potential to participate with strong local and foreign partners in the new takaful operators will open up significant opportunities to expand their product offerings to include a comprehensive range of insurance and takaful products. Existing takaful operators will therefore need to review their business and management strategies in response to the increased competitive elements that are set to shape the takaful industry.

Malaysia has also moved strategically to establish closer economic linkages and integration with our neighbours to enable Malaysian businesses to tap the vast commercial opportunities present in Asia. The Government has already started negotiations on a number of free trade agreements that will open doors to greater market access in the growth economies within the region. These negotiations are currently now at various stages. We remain confident of achieving a positive outcome that will be balanced and mutually beneficial. Specific opportunities for expansion abroad by Islamic financial institutions, in particular, are also being further enhanced through various bilateral and multilateral arrangements. This includes the signing of a memorandum of understanding between Malaysia and the Islamic Development Bank in 2004 to enhance cooperation among member countries of the Organisation of Islamic Conference, or OIC, in the areas of trade, investment, islamic finance and ICT development. These initiatives will pave the way for Malaysian takaful operators to promote and expand takaful and retakaful business to key target markets abroad, in particular, within the OIC.

The net benefits that will ultimately accrue to Malaysia will depend on the ability of Malaysian institutions to develop targeted globalisation strategies that will position them to gain from the first-mover advantages where they arise. This needs to be reinforced with research into the new growth markets, and exploring opportunities for strategic alliances or joint ventures in these markets. At the same time, the growth strategies must also accord an equal inward focus on reinforcing financial strength and resilience, human capital development, a strong business reputation and high standards of service and professionalism all of which are the critical success factors for effective strategies abroad.

Maintaining financial stability remains a primary mandate of the Central Bank. In response to the constantly changing financial landscape, Bank Negara Malaysia's approach to the regulation and supervision of the insurance and takaful sectors has evolved to achieve a more robust regime that emphasises three key dimensions: first, creating a strong risk management culture that overlays the operations of insurers and takaful operators; second, facilitating market-led adjustments that will allow the industry to evolve in response to market, technological and demographic developments, while maintaining sufficient regulatory oversight to maintain financial stability and public confidence; and third, ensuring mutually consistent policies for the banking and insurance sectors.

Two fundamental changes underpinning the Bank's current approach to regulation and supervision are the shift towards "principle-based" regulations and the implementation of a risk-based regulatory and supervisory regime. Increasingly, regulations have focused less on prescriptive rules, and more on establishing the broad parameters for sound financial and business practices that provide substantial flexibility for insurers and takaful operators to apply the principles in the manner most appropriate to their specific circumstances. Under this approach, greater attention is also being given to the creation of appropriate incentives within the system to achieve the desired outcomes.

The adoption of "principle-based" regulations is complemented by an increased focus on risk management in the capital and supervisory framework. On this front, I am encouraged by the industry's positive response to the new risk-based supervisory framework implemented for the insurance and takaful industries since August 2004. The new approach amplifies the focus on institution-specific risks in the supervisory assessment and rating process. Importantly, the framework serves to mutually enhance understanding by the institutions and the Central Bank of the inherent risks faced by the respective institutions, and thereby establish the common expectations regarding the management and control of those risks, taking into account the nature, scope, complexity and risk profile of the institution. This process, in turn, facilitates appropriate supervisory and institutional responses that are proportionate to the risk assessments of individual institutions and their systemic impact.

Similarly, the implementation of the risk-based capital framework for insurers will further reinforce the regulatory focus on risk. The adjustments to this framework will take into account the feedback received from the industry on the concept paper released by Bank Negara Malaysia in December last year, as well as the results of the impact study that was concurrently carried out to assess the potential capital adjustments required by insurers. Specifically, the adjustments to the framework are being made to achieve greater consistency between the valuation bases for assets and liabilities, and to fine-tune the asset risk charges. A second consultation paper, incorporating these changes, will be released for further industry comments later this year.

Insurers will no doubt welcome the greater degree of investment flexibility that will be allowed under the risk-based capital framework. It is an important improvement over the current "admitted assets" framework, and one that is also expected to significantly raise the profile of the investment management function within the industry. As the scope for differentiation between institutions increases under the risk-based regime, it will become more critical for insurers to attract, develop and retain the right human capital resources. With the liberalisation of financial markets and the rapid pace of financial convergence, the investment management function within insurers needs to be flexible, risk-focused, and equipped with professionals who are able to respond to the exigencies of the marketplace.

An important component of the new risk-based capital and supervisory framework is the notion of supervisory target capital levels which insurers will be required to maintain under the risk-based framework. This is new to our environment, and has been a matter of some concern to insurers which may view it as an additional capital burden. Although the risk-based capital regime will more closely align economic capital with regulatory capital, it is important to recognize that it necessarily derives its application from industry-wide tests which cannot fully address risks that are specific to an individual institution. The supervisory capital target therefore serves to provide an early signal of emerging difficulties so that appropriate intervention measures can be taken to prevent a further deterioration of conditions which would warrant more drastic and costly actions. For insurers that already adopt robust internal approaches to capital management, the introduction of the supervisory target level in itself should not significantly alter existing capital management strategies. Insurers that do not yet have such systems in place, will be encouraged to develop them, and thereby enhance their own resilience to adverse changes in business conditions.

The Bank is mindful that developments internationally on this front remain extremely fluid. Work is still in progress on the International Financial Reporting Standard for Insurance Contracts, the Solvency II initiative in the European Union, and the development of cornerstones for solvency assessments by the International Association of Insurance Supervisors. The Bank will therefore continue to maintain an open consultative approach in proceeding with this initiative to preserve our ability to respond appropriately and to ensure its smooth implementation.

Going forward, greater attention will be given to market conduct issues, which recent experience in other markets has shown to be an increasingly important factor in promoting confidence in the insurance and takaful industries. Financial markets cannot operate efficiently and effectively unless market participants act with integrity. This needs to be reinforced with adequate information to consumers and investors to make informed decisions. In today's information era, the business environment has changed dramatically, and with it, the expectations of consumers and investors have also increased. The industry needs to adapt accordingly.

Policy initiatives by Bank Negara Malaysia in the area of market conduct will continue to focus on achieving complete, true and plain disclosures to consumers, thereby equipping consumers to make informed decisions essentially through consumer education initiatives, and ultimately, promoting the fair treatment of policyholders. In this connection, I am pleased to announce that after more than two years of extensive discussions with the industry, the revised Guidelines on Medical and Health Insurance Business have now been finalized. The Guidelines will be released to the industry this month for implementation early next year. This is an important strategic development, both from the public policy and consumer perspectives. Today, medical insurance business accounts for the largest share[1] of non-tariff general insurance premiums in the market, with premiums exceeding RM1.3 billion in 2004. The revised Guidelines have retained a significant degree of product flexibility, and enhanced disclosure requirements to promote increased competition while more clearly defined rules governing minimum policy terms and conditions will be put in place to deliver a reasonable level of protection to policyholders. These requirements will also promote more consistent treatment of consumers in the provision of core benefits under medical insurance policies.

Where regulatory intervention remains necessary, the Bank will continue to balance the business interests of industry participants with that of consumers, to ensure that the costs of regulation are commensurate with its perceived benefits to consumers. In the long term, however, reliance on regulation and supervisory oversight alone is not a sustainable solution to the market conduct and broader confidence issues that confront the industry. The desired outcome should be one where freedom of action is accompanied by an appropriate degree of moral restraint on the part of the market. This requires compatible incentives in the system and a strong ethical foundation built within institutions which will ensure that insurers and takaful operators act responsibly within an environment that allows greater business flexibility.

The strategic issues before us today concern the industry's responsibility to deliver a fair proposition to consumers, its relevance in the changing environment and its readiness in terms of capacity and infrastructure to support and sustain a successful strategy for growth.

It is hoped that discussions at this dialogue will contribute towards the thinking on future corporate strategies as well as on the regulatory responses to ensure sound development. This will be an opportunity to engage actively in the discussions on these keys issues confronting the industry in moving forward. I wish you a successful and productive dialogue.

[1] 10.5% of total general gross direct premiums, third (in terms of market share) only to motor and fire business.

ASLI's World Islamic Economic Forum
1 October 2005, Kuala Lumpur

"Metamorphosis into an International Islamic Banking and Financial Hub"

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

In evolving the Islamic financial system, important considerations include the development of a system that is able to meet the changing requirements of the consumer and business community, that is efficient and competitive, that is safe and sound and that is robust and resilient and able to withstand a more challenging and uncertain world environment. These considerations are vital to ensure the sustainability of the system not only as a form of financial intermediation in the domestic economy but also as an integral component of the international financial system.

Evolving a Robust Islamic Financial System

Malaysia has adopted a holistic approach in developing its Islamic financial system. Our initial focus was to develop a comprehensive domestic Islamic financial system. The strategy has been to institute the entire financial system chain to ensure its smooth functioning thereby contributing to a balanced allocation of financial and economic resources within the economy, and a greater diversification of risks within the system, and thus achieving overall stability of the Islamic financial system. The initiatives taken include building the required financial institutions, robust regulatory and supervisory framework, effective legal and Shariah framework, the financial markets, effective payment and settlement system, reinforced by the development of the skill talents, and putting in place the mechanism for the operation of the Central Bank. The development of this chain has promoted greater linkages and integration within the domestic Islamic financial system.

Attention has therefore been given to the development of the key structural components of the system, comprising the Islamic banking industry, the takaful industry, the non-banking institutions and the Islamic interbank and capital markets. These respective components of the Islamic financial system have now become highly integrated and interdependent. This more diversified financial infrastructure has also enhanced the efficiency in the functioning of the overall financial system.

The development of the Islamic financial system in Malaysia started with the establishment of *Tabung Haji* in 1969 as the

first Islamic savings institution. This was followed by the establishment of full-fledged Islamic banking and non-banking institutions. A year after the establishment of the first Islamic Bank in 1983, a takaful or Islamic insurance company was established under the Takaful Act. These developments were subsequently expanded with the introduction of Islamic windows by conventional banking institutions where Islamic products and services could be offered by these banking institutions. At the same time, adequate firewalls have been instituted to ensure absolute separation of banking operations to avoid co-mingling between the Islamic and conventional funds so as to ensure the integrity of the Islamic banking operations.

More recently, this structure has been strengthened. Conventional banking institutions that have achieved a critical mass in their Islamic finance operations have the option to transform their operations into a dedicated Islamic subsidiary. Within this framework, Islamic finance in Malaysia has proven to be resilient and able to function effectively and efficiently alongside the conventional financial system. The ability of the Islamic banking institutions to arrange and offer products with attractive and innovative features at competitive prices has appealed to both Muslim and non-Muslim customers, reflecting the competitiveness of Islamic finance as a form of financial intermediation. Since 2000, the domestic Islamic banking industry has been growing at an average of 18% per annum in terms of assets, while growth in the takaful industry was at an average of 28% per annum, with an increasingly more important role in supporting the growth and development process of the country.

Attention has also been given to develop both the Malaysian Islamic money market and capital market. A wide range of instruments has been developed to facilitate the effective management of liquidity and funding by the Islamic financial institutions. This has facilitated the smooth flow of funds in the Islamic financial system. With the development of the bond market in Malaysia which now accounts for 81% of GDP, the Islamic private debt securities account for about 44% of the total outstanding amount of private debt securities in the market, while the monthly traded volume of the Islamic money market is now about RM30 to RM40 billion. The money market also effectively serves as a channel for the conduct of liquidity operations by Bank Negara Malaysia as part of its monetary policy.

The rapid expansion of the Islamic financial services industry in Malaysia is also supported by a conducive legal and Shariah framework. In terms of the legal infrastructure, the Islamic Banking Act 1983 and Takaful Act 1984 governs the conduct of the Islamic banking institutions and takaful operators respectively. There is also the Government Funding Act which governs the issuance of government Islamic instruments. A dedicated High Court judge has also been assigned to preside over cases relating to Islamic banking and finance. An arbitration centre is also available to deal with disputes. The Central Bank Act has also been amended to provide for the establishment of a Shariah Advisory Council at the Central Bank as the

sole authority and reference on all Shariah matters. The treatment of tax neutrality has also been accorded to Islamic financial transactions.

To ensure the soundness and stability of the Islamic financial system the regulatory and supervisory framework has also been improved for the Islamic financial institutions, with the incorporation of stronger standards for corporate governance, transparency, disclosure, accountability, market discipline, risk management and customer protection. In addition, the payment system has also been continually upgraded to ensure efficient and effective clearing and settlement of payments. It is now highly automated with the ability to handle scriptless debt securities trading, processing and settlement. By providing a real time settlement system for inter-bank fund transfers, the credit and settlement risk in the Islamic financial system has been minimised.

Attention has also been given to human talent management to create a sufficient pool of competent bankers essential to spearhead innovation in Islamic financial products and services. To meet the increasing manpower requirements, institutions of higher learning and the Islamic banking and finance institutes have also initiated new programmes on Islamic finance.

Leading initiatives in the global integration

Islamic finance in Malaysia has now taken on a new dimension to become more internationally integrated. This is part of the strategy to evolve Malaysia as an integrated international Islamic financial hub that will have a greater role in facilitating international economic and financial flows.

The liberalisation of the Islamic financial system in Malaysia commenced in 2004 with the issuance of three new Islamic bank licences to foreign Islamic financial institutions. These new entrants with distinct capabilities and strengths will not only participate in the growing domestic Islamic banking industry, but will also be able to tap new markets in the region. This initiative will also promote healthy competition, thereby contributing to elevate the domestic industry to new levels of dynamism. In addition to this initiative, up to 49% foreign interest is permitted in the Islamic subsidiaries of the conventional banking institutions and in the takaful companies. The increased international integration is also reinforced by our own institutions venturing beyond our domestic borders, in particular to the Asian region and to the Middle East. This international integration would contribute towards facilitating greater cross-border flows in terms of increased trade and investment transactions, thereby strengthening the global economic and financial inter-linkages.

Apart from banking, Malaysia is also initiating efforts to promote takaful internationally. This is being done in close coordination with the Islamic Development Bank where a taskforce has been established to spearhead, among others, the development and promotion of trade, investment, Islamic banking as well as takaful and retakaful industries among OIC member countries.

Among the main initiatives to be undertaken under a Memorandum of Understanding signed between Malaysia and the Islamic Development Bank is to specifically promote and expand takaful and retakaful businesses in the member countries.

A further initiative by Malaysia was to access the international capital market with the issuance of global Islamic financial instruments. The Government of Malaysia made this inaugural primary issuance of a globally-accepted sovereign Islamic *sukuk* in 2002. Since then, there have been several other issues by other countries. To-date, the total issuance of the four global sovereign *sukuk* has exceeded USD3.5 billion. The *sukuk* has broadened the investor base by creating a new asset class for both Islamic and conventional investors. This has also been followed by the issuance of global corporate *sukuk,* which now amounts to USD12 billion. Several of these products are listed on the Labuan international financial exchange.

In 2004, Malaysia liberalised the foreign exchange administrative rules to allow Multilateral Development Banks and multinational corporations to raise ringgit-denominated instruments in the Malaysian capital market. Towards this end, two institutions, the International Finance Corporation and the World Bank, have issued ringgit-denominated instruments based on Islamic principles in our market. This has contributed to enhancing the depth of the market.

At the international level, Malaysia has also participated actively in initiatives to develop the supporting international Islamic financial architecture. The formation of the Islamic Financial Services Board (IFSB) in 2002 is one of the most important achievements in this development to set the international prudential standards for Islamic finance. To-date, the IFSB has made commendable progress, and this includes the issuance of two exposure drafts on capital adequacy and on risk management. Work is in progress for three other standards that relate to corporate governance, transparency and market discipline, and the supervisory review process. The IFSB has also played a catalytic role in expanding its membership and outreach, thereby contributing further to the global recognition of the Islamic financial system. Today, the IFSB has 78 members from all over the world. This will contribute towards the standardisation of the prudential rules and more importantly contribute to the soundness and stability of the Islamic financial system.

The International Islamic Financial Market, or the IIFM, which is another leading international initiative, will also contribute towards promoting the development of both the primary and secondary international Islamic financial market. IIFM provides the environment to link all the financial centres around the world that participate in Islamic finance, thereby encouraging active participation by both Islamic and non-Islamic financial institutions in the secondary market for Islamic financial instruments. As the volume increases, it would strengthen the inter-linkages and integration amongst the Islamic financial centres.

In the area of Shariah, Bank Negara Malaysia is currently promoting intellectual discourse on Shariah issues. Our own Shariah scholars have contributed towards the rapid growth of the Islamic financial products. Earlier this year in conjunction with the IDB Annual General Meeting that was held in Putrajaya, the opportunity was taken to bring the international Shariah scholars together to deliberate the issues and to foster greater understanding and convergence of the practices of Shariah. Bank Negara Malaysia has established a RM200 million dedicated endowment fund to facilitate regular dialogues among the Shariah scholars, to finance research and scholarships, and to facilitate enhanced interaction between the Shariah scholars and the industry practitioners.

Malaysia will continue to initiate international endeavours and collaborate closely with the Islamic financial community on developing the global Islamic financial system by dedicating our resources and commitment.

Key challenges moving forward

One of the key challenges in promoting greater linkages within the domestic Islamic financial system and integration with the international financial system is having the pool of talent and professional skills. Talents are an important pre-requisite for the national and global development of the Islamic financial system. They are important assets that will drive innovation in the Islamic financial business and sustain its competitive strength.

As the industry moves forward, the need to develop the range of products and services including risk-mitigating products intensifies. These products are a necessity for the Islamic financial industry not only to meet the new and changing requirements of the domestic and international economy but also to allow for hedging against potential adverse events and uncertainties. This is important to strengthen the resilience and risk management framework of the Islamic financial industry amidst the increasingly more challenging and competitive global financial environment.

To fast track the creation of a pool of talents and skill set to meet the increasing manpower requirements, Malaysia is currently undertaking an initiative to establish an international centre for education in Islamic finance. It will be designed to act as a professional certification body and a training institute for post-graduates. In addition, Malaysia established the International Centre for Leadership in Finance (ICLIF) in 2003 to also provide leadership development and management training for the Islamic financial institutions.

Closely linked to having the talent is the need to have strong and well established Islamic financial institutions. This presents another challenge for the Islamic financial industry as there are currently not many large Islamic financial institutions. Many of the players are not large enough globally to finance large development projects, particularly in Muslim countries and are not strong enough to underwrite the needs of the Islamic financial community on a large scale. Currently, some of the project financing in

Muslim nations are undertaken by large conventional banks because of the under capitalisation of the Islamic financial institutions. We therefore need to have strong and highly capitalised Islamic financial institutions that are able to offer the comprehensive and complete range of Islamic financial products and services.

Besides having large Islamic financial players with the required pool of expertise, the integration of the Islamic financial system with the international financial system needs to be supported by the development of a full Islamic financial system at the national level, thereby increasing the potential to effectively participate in a more liberalised and globalised environment.

Towards this end, Malaysia together with other OIC countries, are collaborating with the IDB and IFSB to formulate a ten-year master plan for the future global development of the Islamic financial services industry. The Master Plan will provide a road map to achieve a convergence towards the common vision among countries in the development of an Islamic financial system.

Conclusion

In developing and strengthening our Islamic banking and financial system to become more integrated with the international financial system, Malaysia is positioning itself as an Islamic financial gateway to the East Asian region. In emerging on the radar screen of international investors, Malaysia thus not only offering financial communities that want to deal in Islamic financial transactions, but also the international investment community at large, the potential for further opportunities for financing and investment in productive activities.

In closing, I wish to say that our mission is for the development of an increasingly international integrated Islamic financial system. I am confident that in taking this approach, it would contribute towards facilitating increased trade and investment transactions, strengthening the global economic and financial inter-linkages, and thereby raising the prospects for more balanced global growth and shared prosperity among the *Ummah*, InsyaAllah.

Calendar of Events
July – September 2005

13–15 July 2005

The Bank and the European Commission (EC) jointly organised a conference titled "Expanding ASEAN-EU Economic Links – The Role of Euro". The conference, the first of its kind in the ASEAN region, explored issues in further strengthening the ASEAN-EU economic and financial relations against the backdrop of the increasing role of the euro in Asia and in the international financial system.

18 July 2005

The ABF Malaysian Bond Index Fund, the first Exchange Traded Fund in Malaysia and the second of its kind among the EMEAP (Executive Meeting of East-Asia and Pacific Central Banks) countries, was listed on Bursa Malaysia. It represented the successful implementation of the Asian Bond Fund (ABF) project to accelerate the development of the domestic bond market and to promote greater integration among the regional bond markets.

19 July 2005

During the official launch of Hong Leong Islamic Bank Berhad (HLIBB), the Governor said that Islamic financial institutions in the country need to take on a more active role in promoting Islamic finance and complement the efforts of the Bank and the Government, so that there will be increased potential for Malaysia to evolve as an Islamic financial centre. HLIBB is the Islamic banking subsidiary of Hong Leong Bank Berhad.

21 July 2005

The Bank announced that the ringgit exchange rate will be allowed to operate in a managed float, with its value being determined by economic fundamentals. The exchange rate will be monitored against a currency basket to ensure that it remains close to its fair value. Promoting stability of the exchange rate continues to be a primary objective of the policy.

4 August 2005

The Governor delivered a keynote address at the Public-Private Dialogue Session of the 7th SEACEN Conference of Directors of Supervision of Asia Pacific Economies that was held in Kuala Lumpur, in which she spoke about the cross-border challenges in implementing Basel II in emerging economies.

9–10 August 2005

The Bank with the insurance and takaful industries held their regular dialogue session themed "Moving Towards a More Competitive Market", to discuss issues confronting the insurance and

takaful industries, major policy initiatives by Bank Negara Malaysia as well as current economic and financial developments affecting both industries.

24 August 2005

The Bank announced that the Malaysian economy expanded by 4.1% in the second quarter of 2005. The Bank also stated that given an environment where inflation is increasing, the level of monetary accommodation will be balanced to ensure that the maximum sustainable growth is achieved in an environment of price stability. The overnight policy rate (OPR) remained unchanged at 2.70%.

26 August 2005

The Bank issued a revised Guideline on Medical and Health Insurance Business to promote a more equitable and consistent treatment of consumers by both general and life insurance companies.

29 August 2005

The Bank announced the eighth and final issuance of Bon Simpanan Merdeka (BSM) amounting to RM430 million which was subsequently issued on 1 October 2005. The bond provides an additional savings instrument to senior citizens, retired Malaysian Armed Forces personnel, as well as Malaysian citizens who have retired on medical grounds. Since the first issue in February 2004, the eight series of BSM attracted subscriptions amounting to RM3.5 billion from 93,300 investors in the target groups; with 60% of them investing RM40,000 and below.

1 September 2005

Following the approval of the Minister of Finance, the Bank announced the introduction of a deposit insurance system for Malaysia to further strengthen the country's financial consumer protection infrastructure. The Bank also announced the establishment of the Malaysia Deposit Insurance Corporation to administer the system.

5 September 2005

The Bank announced that effective 7 December 2005, the RM1 coin will cease to be legal tender and will be withdrawn from circulation.

12 September 2005

At the International CEO Forum of the Development Finance Institutions (DFIs) 2005, Deputy Governor Datuk Zamani Abdul Ghani spoke about the role of DFIs in the financial system from the Malaysian perspective.

16 September 2005

The Bank announced that the Financial Services Resource Centre (FSRC) has reached an important milestone with the award of the construction contract. The FSRC represents an investment in a knowledge centre with learning and research facilities to support the SEACEN Research and Training Centre, the Islamic Financial Services Board and the Bank itself.

20 September 2005

At the 2nd Annual Asian Islamic Banking & Finance Summit, Deputy Governor Datuk Zamani Abdul Ghani said that to accelerate the growth of Islamic financial services industry through effective linkages and integration, four areas deserve greater attention:

- Building the necessary infrastructure to facilitate efficient capital and trade flows;
- Creating vibrant financial markets;
- Strengthening information sharing and human talent management; and
- Promoting the adoption of standard regulation and market practices.

26 September 2005

The Governor delivered a statement at the Joint Annual Discussion of the Boards of Governors at the 2005 World Bank-IMF Annual Meeting, in which she stressed the need for a greater engagement with the entire spectrum of member countries, including the emerging and developing economies. In increasing the prospects for a greater shared global economic prosperity, “it is important for voices from the constituency of the emerging and developing world to not only be heard but to be listened to,” the Governor said.