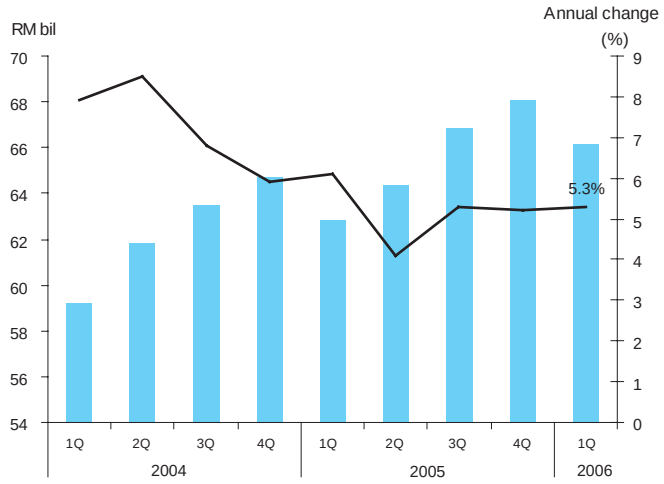
ECONOMIC AND FINANCIAL DEVELOPMENTS IN MALAYSIA IN THE FIRST QUARTER OF 2006

OVERVIEW

Economic activity was sustained in the first quarter

The growth momentum of the Malaysian economy was maintained with real gross domestic product (GDP) rising by 5.3% in the first quarter of 2006 (4Q 2005: 5.2%). Economic activity continued to be driven by the private sector. The key contributors to the growth were the manufacturing and services sectors, with the strong performance in the agriculture sector lending further support.

Sustained GDP growth in 1Q 2006



Valued-added growth in the manufacturing sector continued on its upward trend to expand by 8% (4Q 2005: 7.9%) in line with recovery in the global semiconductor cycle. This strong performance was led mainly by stronger growth in the electronics and electrical products industry (16.7%; 4Q 2005:10.5%), with all major categories of products recording growth. The computer segment in particular, benefited from strong buying interest as a result of lower prices as well as increased demand for laptops due to increasing popularity of wireless systems. Valued-added growth in the manufacturing sector was further reinforced by the stronger expansion in the textiles, wearing apparel and footwear industry (10.5%; 4Q 2005: 10.3%). Output of the chemical and petroleum products industries also expanded, albeit at a more moderate pace (4.4% and 8.9% respectively) due to slower external demand for intermediate plastic materials and lower production of natural gas.

The services sector continued to expand by 5.2% supported by trade, consumption and tourism-related activities. Of significance, the finance, insurance, real estate and business services; and wholesale, retail trade, hotels and restaurants performed favourably. Growth in the agriculture sector strengthened significantly to 7.3% underpinned by higher output of rubber, cocoa, fish, paddy, fruits and vegetables which more than offset the lower activity in the crude palm oil sub-sector. Meanwhile, the construction and mining sectors continued to decline. The construction sector was affected by weak civil engineering activities and some moderation in demand for residential properties. The decline in the mining sector was due to lower production of crude oil including condensates (-2.2%; 724,166 barrels per day) and natural gas (-5.9%; 5,974 million standard cubic feet per day).

Domestic demand remained robust registering a growth of 7.6%. Gross fixed capital formation strengthened further, registering a growth of 11.4%. Of significance, the rise was supported mainly by private investment activities. Spurred by the better business outlook and

the sustained high capacity utilisation, businesses upgraded and expanded their productive capacity, and undertook new investments in downstream activities. Indicators of investment supported the strong investment pattern. Imports of capital goods and sales of commercial vehicles both recorded strong double-digit growth. Loans approved and disbursed to businesses were also sustained. Although Federal Government development expenditure was lower, public investment continued to focus on essential projects, such as agriculture and rural development, public utilities, education and health services.

Purchases of new passenger cars, an important component in consumption demand, recorded a decline during the quarter as consumers deferred purchases with the impending announcement of the National Automotive Policy. At the end of February, consumers were also affected by the increases in the retail price of fuel and gas. Despite these developments, private consumption expenditure remained strong, increasing by 7.5% during the quarter. Other major consumption indicators, such as imports of consumption goods and credit card spending, registered strong growth. Financing conditions, while normalising, remained supportive, as shown by the sustained growth in loans approved and disbursed for consumption purposes. The level of public consumption was sustained, registering a growth of 0.1%, with higher expenditure on emoluments and defence. The overall fiscal position showed a surplus of 3.8% of GDP (1Q 2005: +2.3% of GDP) as stronger revenue collection more than offset the increase in total expenditure.

The annual rate of inflation, as measured by the Consumer Price Index (CPI), increased to average 3.7% in 1Q 2006 (4Q 2005: 3.4%). This mainly reflected the 18% increase in retail fuel prices on 28 February 2006, resulting in the upward adjustment in the rate of inflation to 4.8% in March. Conditions in the labour market continued to be healthy with vacancies remaining high and both retrenchments and unplaced jobseekers declining further.

On the external front, the trade surplus narrowed to RM25.8 billion (4Q 2005: RM28.6 billion) as growth in gross imports (13.7%) was higher relative to gross exports (11.5%). Growth in gross exports was led mainly by strong growth in commodity exports, particularly minerals, and continued double-digit expansion in manufactured exports (10.6%). The manufactured exports were led by resource-based products and transport equipment. Although shipment of computers and computer-related products was robust, growth in exports of electronics and electrical (E&E) products as a whole was more moderate at 8.4% (4Q 2005: 14.7%) due to slower growth in exports of electrical appliances. The moderation in growth in E&E export receipts during the quarter was partly attributable to lower prices of some products as a result of intense competition.

Receipts from mineral exports rose sharply by 24% due to the strong increase in energy prices. The export price for crude oil from Malaysia in the first quarter averaged USD65.32 per barrel and that of liquefied natural gas increased by 19.6% to an average of RM1,041 per tonne. Agriculture exports, meanwhile increased further by 5%, mainly supported by the sharp increase in rubber exports (48%). The strong increase in rubber exports was due to the increase in prices (43.7%). Natural rubber prices were higher on account of strong global demand from the automotive sector; the substitution from the more expensive synthetic rubber, which is made from petrochemicals, to natural rubber; and depleting global rubber stocks. Although the volume of palm oil exports increased (3.5%), receipts declined moderately (-1.3%) due entirely to lower prices compared with the corresponding period of 2005. Nonetheless, the export price of palm oil continued to remain attractive at RM1,420 per tonne.

Gross imports strengthened reflecting stronger private investment activity, domestic consumer spending as well as continued expansion in inputs for manufactured exports. Imports of capital goods, expanded at a significantly high rate of 28.8%. Strong external demand for

commodity exports and expansion in intra-regional travel led to an increase in deliveries of ships, aircraft and rail locomotives. Excluding these lumpy items, imports of capital goods increased by 12.3%. As shown by the imports of machinery for manufacturing, metal tools, office equipments and generators, turbines and electric motors, the increase in imports was for capacity expansion and upgrading of technology in the manufacturing and services sectors. Increased exploration and development activity in the upstream oil and gas industry also led to higher imports of construction and mining equipment. Imports of intermediate goods, particularly inputs for the E&E products, also expanded at a stronger rate of 8%. Reflecting higher demand for food and beverages for festivals celebrated during the quarter, imports of consumption goods also increased by 14.1%.

In the financial account, foreign direct investment (FDI), as captured by Bank Negara Malaysia's Cash BOP system, recorded a net inflow of RM0.9 billion. These inflows were broad based and channeled mainly into the services, manufacturing and oil and gas sectors. It should be noted that this FDI data only captures new financial flows and it does not include retained earnings that have been reinvested in Malaysia and investment in the form of imported machinery and equipment. There was also a net inflow in portfolio investment of RM3.9 billion. For overseas investment, there was a net outflow of RM1.8 billion.

The international reserves of Bank Negara Malaysia amounted to RM271.6 billion (USD73.7 billion) as at 31 March 2006. As at 15 May 2006, the reserves amounted to RM289.5 billion (USD78.6 billion), sufficient to finance 8.2 months of retained imports and is 6.6 times the short-term external debt.

Monetary policy remained supportive of economic activity

In the first quarter of 2006, economic indicators continued to point toward sustained economic growth, supported by sustained private sector demand and strong economic growth in the global and regional economies. The rate of inflation was, however, expected to remain at an elevated level for some time. Thus, to align the interest rates to current economic conditions and outlook, the Overnight Policy Rate (OPR) was raised by 25 basis points to 3.25% on 22 February 2006 and by another 25 basis points to 3.50% on 26 April 2006. Despite these two increases, interest rates continue to remain below the neutral level and thus, monetary policy continued to remain supportive of economic activity.

The daily weighted average overnight interbank rate moved within a range of 2.98% - 3.25% during the first quarter of 2006 (4Q 2005: 2.69% - 3.01%). Following the increase in the OPR on 26 April 2006, the daily weighted average overnight interbank rate moved within a range of 3.46% - 3.50% during the period 27 April to 26 May 2006. Interbank rates of other maturities also rose. In terms of retail interest rates, the average base lending rate (BLR) of commercial banks (CBs) increased to 6.72% as at 15 May 2006 (4Q 2005: 6.20%). The average quoted fixed deposit (FD) rates of CBs for the 1-month to 12-month maturities also edged upwards to between 3.11% and 3.73% (4Q 2005: 3.01% and 3.70%). In particular, the increase was evident in FD rates for the 6-month and 9-month maturities, which increased to 3.31% and 3.43% respectively (4Q 2005: 3.04% and 3.08% respectively).

Growth in private sector financing was sustained in the first quarter of 2006, with banking system loans and private debt securities (PDS) outstanding expanding at a combined annual rate of 9.1% (4Q 2005: 9.3%). Bank lending activity remained firm, with total loans outstanding expanding at an annual rate of 8.4% at the end of the quarter (4Q 2005: 8.6%), driven mainly by household loans, which increased at an annual rate of 14.5% (4Q 2005: 15.1%). Loans outstanding to businesses also continued to expand, at an annual rate of 2.7% (4Q 2005: 3%).

Net funds raised by the public and private sectors through the capital market amounted to RM8 billion in the first quarter of 2006 (4Q 2005: RM12.6 billion). On a gross basis, a total

of RM10.6 billion (4Q 2005: RM15.2 billion) was raised through the PDS market by 25 corporations, mainly from the construction and services sectors. Most of the funds raised (78.2%) were for the financing of new activities.

Narrow money, M1, expanded at an annual rate of 5.7% at the end of the first quarter (4Q 2005: 8.5%), while broad money, M3, increased by 6.2% (4Q 2005: 8%). The more modest pace of M3 growth mainly reflected the slower rate of increase in net external operations.

In the first quarter of 2006, the ringgit appreciated against the major currencies. The ringgit strengthened against the US dollar amidst a strong trade and capital account performance, renewed capital flows and brighter economic prospects. The ringgit, however, depreciated against most regional currencies in the range of 0.3% - 5.4%, while appreciating by 1.9% against the Chinese renminbi. Over the period 1 April – 29 May 2006 period, the ringgit continued to strengthen against the US dollar. Against regional currencies, the ringgit appreciated in the range of 1.5% - 4.8% against the Philippine peso, Indonesian rupiah and Chinese renminbi, while depreciating in the range of 0.2% -1.4% against the Korean won, Singapore dollar and Thai baht.

The banking system remained strong

The banking system remained strong in the first quarter of 2006. The risk- weighted capital ratio (RWCR) was 13.1% as at end-March 2006. Pre-tax profits for the quarter amounted to RM3.2 billion. This strong performance was on account of higher net interest and fee-based income as well as higher net gains from trading activities.

Asset quality of the banking system continued to improve primarily as loans turn performing, recoveries improved and due to write-offs. With the decline in non-performing loans, the net NPL ratio improved to 4.5% based on the 6-month classification and 5.7% based on the 3-month classification, the lowest levels since the Asian financial crisis.

Near term outlook remains positive

The strong and broad-based improvement in global economic growth in the first quarter in the face of sustained high oil price and normalisation of financial conditions demonstrates improved resilience of the global economy. The United States economy grew at its fastest pace in 2½ years at 5.3% during the first quarter as a result of strong spending and investment activities. In Japan, economic indicators continued to largely reflect steady economic recovery. The Tankan Survey showed that the outlook for business conditions, especially for large firms, remained favourable for the first half of 2006, with growth in capital expenditure and employment. In the euro area, economic activity strengthened to 2%. In Germany, first quarter growth improved by 1.4% supported by improvements in domestic demand, particularly in fixed investment spending and final household consumption expenditure. In the United Kingdom, estimates show that the economy expanded 2.2% in the first quarter, supported by an expansion in manufacturing production and the services sector. Similarly, growth in the Asian region remained strong supported by the pick up in demand for electronics and electrical goods which led to strong export performance.

Prospects for the global economy in the remaining part of 2006 continues to remain positive. The global economy remains in a position to absorb the high oil prices. The International Energy Agency's forecast of the demand for oil in 2006, a factor driving the prices upwards, has also been lowered as near-record prices have led to some moderation in demand. In this favorable external environment, export growth for Malaysia is expected to be sustained at double-digit levels in 2006 underpinned by global demand for semiconductors and higher commodity export earnings. Domestic demand is also expected to be sustained. The increased

allocation for development expenditure under the Ninth Malaysia Plan, and additional funding under the Private Finance Initiatives (PFI) are also expected to lead to an improvement in the construction sector as new projects and the various PFI infrastructure and utilities projects commence.

Forward-looking indicators of domestic economic activities also suggest sustained economic expansion. Of significance is the optimism in the business community which is expected to accelerate the growth in private investment. The MIER Business Confidence Index increased by 2 points to 102.5 points in the first quarter. In addition, despite the increase in global oil price, the DOSM leading index also registered favourable growth. The latest six-month smoothed growth rate of the Leading Index at 3.7% suggests that economic growth will be sustained in the remaining part of 2006.

INTERNATIONAL ECONOMIC ENVIRONMENT

Strong growth performance in the global economy

Global economic growth strengthened in the first quarter. The US economy rebounded strongly from the moderate growth rate in the fourth quarter of 2005. In addition, growth in the Asian region remained strong, supported by the electronics upcycle and stronger growth in PR China.

The **US** economy grew at its fastest pace in 2½ years at 5.3% during the first quarter and the expansion was broad-based. Consumption was robust, supported by strong job growth. Nevertheless, the US housing market continued to slow as home sales fell and the number of homes for sale hit a new record high. Government spending rose given the expenditure on reconstruction efforts after the hurricanes on the Gulf Coast in 2005 while business investment was largely driven by spending on equipment and software.

Industrial countries: Real GDP Growth

	2005			2006	Key contributing factors for 1Q growth
	1Q	4Q	Year	1Q[p]	
	Annual change (%)				
US[1]	3.8	1.7	3.5	5.3	Broad-based expansion, supported by strong spending and business investment.
UK	1.9	1.8	1.8	2.2	Supported by growth in industrial production, in particular the manufacturing sector.
Euro zone	1.2	1.8	1.4	2.0	Growth was supported by higher domestic spending in Germany and improved growth in Italy.
Japan[1]	5.9	4.3	2.6	1.9	Supported by firm domestic demand, namely capital spending and private consumption.

[1] Annualised basis
[p] Preliminary
Source: National authorities

In **Japan**, economic indicators continued to largely reflect steady economic recovery. The Tankan Survey showed that the outlook for business conditions, especially for large firms, remained favourable for the first half of 2006, with growth in capital expenditure and employment. In the **euro area,** economic activity expanded by 2.0%. Germany, the region's largest economy grew 1.4% during the quarter following increased domestic demand. This was led particularly by high fixed capital spending as well as increased household consumption spending. Italy also saw improved growth during the quarter, expanding 1.5% due to higher industrial production. Meanwhile, economic activity in the **UK** expanded by 2.2% in the first quarter and was supported mainly by expansion in the manufacturing and services sectors.

Global **monetary policy** remained biased towards tightening. The **US Federal Reserve Board (Fed)** continued to raise interest rate by 25 basis points in January, March, April and May, bringing the Fed funds rate to 5%. The latest statement indicated that some further policy firming may continue to address inflation risks but emphasized that future moves would depend on how the economic outlook unfolds. The **Bank of Japan** removed the quantitative easing framework on 9 March 2006 and is now targeting the overnight call rate. The **European Central Bank (ECB)**, meanwhile, raised its main refinancing rate by 25 basis points in March, bringing its key rates to 2.50%.

Global **crude oil prices** edged up towards the end of first quarter, closing at USD67.30 per barrel on 30 March, the highest level in two months amid concerns over supplies in Nigeria as well as potential supply disruptions in Iran and Iraq and strike threats by energy workers in Europe (France and Norway). Oil prices recorded a new peak in April, reaching USD75.35 per barrel on 21 April after the US government reported a larger-than-expected drop in gasoline inventories. Thus far, the surge in oil costs has yet to significantly slow the growth in oil demand and the global growth.

In the **Asian region**, economic activity remained strong with growth in the first quarter strengthening further in PR China, Singapore and Korea. Meanwhile, continued pick-up in demand for electrical and electronic goods contributed to strong export performance. High oil imports, however, led to a lower trade surplus in some regional countries.

Regional Countries: Real GDP Growth

	2005			2006	Key contributing factors for 1Q growth
	1Q	4Q	Year	1Q	
	Annual change (%)				
PR China	9.9	9.9	9.9	10.3	Driven by strong growth in investment.
Singapore	3.4	8.7	6.4	10.6	Buoyed by strong expansion in the manufacturing and services sectors.
Hong Kong	6.0	7.5	7.3	8.2	Driven by exports, consumer spending and investment in machinery and equipment.
Korea	2.7	5.3	4.0	6.2e	Supported by strength in exports as well as private consumption.
C. Taipei	2.5	6.4	4.1	4.9	Supported by electronic exports and the manufacturing sector.
Indonesia	6.1	4.9	5.6	4.6	Supported by the services and mining sectors.

e Advance estimates
Source: National authorities

Inflation trends in the region were mixed. Inflation in Thailand and Indonesia edged downwards slightly, compared with 4Q 2005 following moderation in food prices. However, inflation has risen in Hong Kong, Singapore and the Philippines mainly due to higher housing rentals, utilities and tighter labour markets. To contain inflationary expectations and limit second-round effects, Korea, Thailand and India have raised interest rates. On 27 April, PR China also raised its one-year lending rates by 27 bps to 5.85% (first increase since October 2004), aimed at slowing strong growth in credit and investment.

In the **foreign exchange market**, the US dollar weakened against most currencies during the quarter. Among the major currencies, the US dollar depreciated against euro and sterling. The euro benefited from the ECB's rate increase and market expectations of reserve diversification by some central banks. Meanwhile, regional currencies appreciated, supported by continued inflows from abroad and optimism about economic growth. The Indonesian rupiah recorded the strongest appreciation due to growing investor confidence in the economy and foreign investor interest in Indonesia's high-yielding bonds.

Going forward, the pace of expansion in the global economy is expected to be sustained. However, the risks to growth remain, mainly from the effect of higher oil and commodity prices.

DEVELOPMENTS IN THE MALAYSIAN ECONOMY

Sustained growth, led by the manufacturing and services sectors

In the first quarter of 2006, the Malaysian economy expanded by 5.3% (4Q 2005: 5.2%). Growth continuing to be driven by the manufacturing and services sectors. The manufacturing sector registered a stronger growth, mainly benefiting from the upward trend in the global semiconductor cycle, while growth in the services sector remained firm, supported by trade, consumption and tourism-related activities. Meanwhile, the performance of the primary commodity sector was mixed. The agriculture sector recorded a strong expansion due to better performance in most of the sub-sectors which more than offset the decline in crude palm oil production. Activity in the mining sector, however, declined due to lower output of crude oil and natural gas.

Quarterly GDP by Kind of Economic Activity at 1987 Prices

	2005			2006
	1Q	4Q	Year	1Q
	Annual Change (%)			
Agriculture	6.1	-1.5	2.5	7.3
Mining	3.4	-2.0	0.8	-3.5
Manufacturing	5.7	7.9	5.1	8.0
Construction	-2.4	-0.6	-1.6	-1.8
Services	6.8	5.9	6.5	5.2
Real GDP (Ann. Chg.)	**6.1**	**5.2**	**5.2**	**5.3**
Real GDP (Preceding Chg.)	**-2.9**	**1.8**	**5.2**	**-2.8**

Source: Department of Statistics, Malaysia

In the **Asian region**, economic activity remained strong with growth in the first quarter strengthening further in PR China, Singapore and Korea. Meanwhile, continued pick-up in demand for electrical and electronic goods contributed to strong export performance. High oil imports, however, led to a lower trade surplus in some regional countries.

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Singapore	3.4	8.7	6.4	10.6	Buoyed by strong expansion in the manufacturing and services sectors.
Hong Kong	6.0	7.5	7.3	8.2	Driven by exports, consumer spending and investment in machinery and equipment.
Korea	2.7	5.3	4.0	6.2e	Supported by strength in exports as well as private consumption.
C. Taipei	2.5	6.4	4.1	4.9	Supported by electronic exports and the manufacturing sector.
Indonesia	6.1	4.9	5.6	4.6	Supported by the services and mining sectors.

e Advance estimates
Source: National authorities

Inflation trends in the region were mixed. Inflation in Thailand and Indonesia edged downwards slightly, compared with 4Q 2005 following moderation in food prices. However, inflation has risen in Hong Kong, Singapore and the Philippines mainly due to higher housing rentals, utilities and tighter labour markets. To contain inflationary expectations and limit second-round effects, Korea, Thailand and India have raised interest rates. On 27 April, PR China also raised its one-year lending rates by 27 bps to 5.85% (first increase since October 2004), aimed at slowing strong growth in credit and investment.

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Going forward, the pace of expansion in the global economy is expected to be sustained. However, the risks to growth remain, mainly from the effect of higher oil and commodity prices.

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Agriculture	6.1	-1.5	2.5	7.3
Mining	3.4	-2.0	0.8	-3.5
Manufacturing	5.7	7.9	5.1	8.0
Construction	-2.4	-0.6	-1.6	-1.8
Services	6.8	5.9	6.5	5.2
Real GDP (Ann. Chg.)	**6.1**	**5.2**	**5.2**	**5.3**
Real GDP (Preceding Chg.)	**-2.9**	**1.8**	**5.2**	**-2.8**

Source: Department of Statistics, Malaysia

The manufacturing sector on an upward trend

Value-added growth in the **manufacturing sector** continued on its upward trend to expand by 8% in the first quarter of 2006 (4Q 2005: 7.9%) in line with the recovery in the global semiconductor cycle. Growth was also supported by improvement in the domestic-oriented industries.

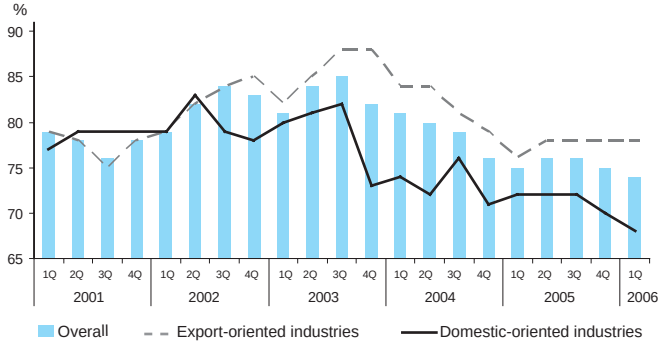
The **export-oriented industries** expanded by 10.1% (4Q 2005: 10.1%), led mainly by stronger growth in the electronics and electrical products (E&E) industry (16.7%; 4Q 2005: 10.5%). Growth was recorded across all major categories of E&E products, including the electrical and semiconductor segments and particularly the computer segment, which benefited from strong buying interest as a result of lower prices as well as the increased demand for laptops due to the popularity of wireless systems. Output of chemical products, meanwhile, grew at a more moderate pace of 4.4% (4Q 2005: 16.8%) reflecting the slower demand for intermediate plastic materials from China. The petroleum products industry also registered a more moderate growth of 8.9% (4Q 2005: 11.5%) in tandem with the lower production of natural gas.

Output in the textiles, wearing apparel and footwear industry continued to expand strongly by 10.5% (4Q 2005: 10.3%). Output of rubber products declined further by 8.3% (4Q 2005: -1.6%) although in terms of exports, the receipts have remained favourable. The main reason for the decline in production was due to a major tyre manufacturer undergoing a transition, shifting into the production of higher-end and more superior quality products.

The **domestic-oriented industries** meanwhile registered a growth of 0.7% in the first quarter of 2006 (4Q 2005: 0.4%), as contraction in the construction-related industries was offset by better performance in the fabricated metal products industry (13.2%; 4Q 2005: -5.7%) and sustained growth in the transport equipment industry (6.5%; 4Q 2005: 6.7%). The iron and steel industry declined at a slower rate of 10.9% (4Q 2005: -13.4%) reflecting in part the gradual recovery in global steel prices. The non-metallic mineral products industry declined by 5.7% (4Q 2005: 1.5%) during the quarter, partly affected by weak construction activities as well as lower production of glass for the shrinking cathode ray tube (CRT)-related products market.

Overall, the **capacity utilisation** rate for the manufacturing sector averaged 74% in the first quarter of 2006 (4Q 2005: 75%) amidst the increase in capacity as a result of higher investment. The export-oriented industries operated at 78% (4Q 2005: 78%), while the domestic-oriented industries at 68% (4Q 2005: 70%) during the quarter.

Capacity Utilisation in the Manufacturing Sector



Performance in the Manufacturing Sector

	2005			2006
	1Q	4Q	Year	1Q
	Annual change (%)			
Value Added (Constant Price)	**5.7**	**7.9**	**5.1**	**8.0**
Overall Production	**4.0**	**8.2**	**5.1**	**8.3**
Export-oriented industries	**3.5**	**10.1**	**5.7**	**10.1**
Of which:				
Electronics and electrical	-1.2	10.5	3.5	16.7
Electronics	-2.2	13.1	5.2	21.5
Electrical	1.7	3.7	-0.8	4.2
Chemicals and chemical products	6.6	16.8	11.0	4.4
Petroleum products[1]	13.4	11.5	10.8	8.9
Textiles, wearing apparel & footwear	-4.3	10.3	3.4	10.5
Wood and wood products [2]	1.3	3.1	1.5	1.9
Rubber products	4.6	-1.6	-0.4	-8.3
Off-estate processing	25.7	-4.6	8.1	-4.9
Domestic-oriented industries	**6.1**	**0.4**	**2.8**	**0.7**
Of which:				
Non-metallic mineral products	4.1	1.5	2.0	-5.7
Iron & steel and non-ferrous metal	1.6	-13.4	-5.3	-10.9
Food	8.6	4.8	7.6	-2.3
Transport equipment	16.0	6.7	8.5	6.5
Fabricated metal products	-6.9	-5.7	-4.9	13.2
Total Manufactured Exports	**12.0**	**13.1**	**10.1**	**10.6**
Of which:				
Electronics and electrical products	9.9	14.7	10.0	8.4
Chemical and chemical products	20.7	4.5	7.0	-6.7
Petroleum products	18.0	20.6	24.7	39.3
Optical & scientific equipment	22.9	12.4	6.5	7.9
Wood and wood products	16.8	6.6	2.1	-3.7
Furniture & parts	10.3	0.8	6.1	8.0
Rubber products	11.9	18.7	12.3	16.7

[1] Under the new Industrial Production Index (2000=100), LNG has been reclassified as petroleum products (previously classified as chemicals and chemical products). Consequently, petroleum products have been reclassified as export-oriented industries.
[2] Output of furniture and parts are not captured in the wood production data.

Source: Department of Statistics, Malaysia

Sustained expansion in the services sector

The **services sector** expanded by 5.2% in the first quarter of 2006 (4Q 2005: 5.9%), supported by trade, consumption and tourism-related activities. Of significance, the finance, insurance, real estate and business services; and wholesale, retail trade, hotels and restaurants sub-sectors continued to perform favourably.

The **finance, insurance, real estate and business services sub-sector** recorded a strong growth of 6% (4Q 2005: 5.8%) led mainly by increased bank lending activities as well as continued growth in the insurance sector, both in the general and life insurance categories. Meanwhile, the business services segment continued to remain strong, due to higher activity from selected businesses that benefited from the better stock market performance during the quarter as well as the higher activity in the shared services and outsourcing (SSO) industry as reflected by the 16 new approvals of MSC-status SSO companies during the quarter.

The **wholesale and retail trade, hotels and restaurants** sub-sector remained resilient to record a sustained growth of 6.1% during the quarter (4Q 2005: 7%). The development was despite the increase in domestic prices of petrol and diesel during the quarter. Growth was supported by continued spending by households amidst the positive earning growth. Robust domestic tourism activity was supported by the special rates on airfares and attractive tour packages offered during the quarter.

Growth in the **transport, storage and communication sub-sector** was supported by both the transportation and telecommunications segments. The transport sector was aided by higher land and port activities in line with the increase in total trade during the quarter. Meanwhile, growth in

Performance in the Services Sector (Value Added)

	Share 2005	2005			2006
		1Q	4Q	Year	1Q
	%	Annual change (%)			
Intermediate Services	**41.5**	**7.1**	**5.5**	**5.9**	**5.4**
Transport, storage & communication	15.1	10.4	4.9	6.2	4.4
Finance, insurance, real estate & business services	26.4	5.2	5.8	5.7	6.0
Final Services	**58.5**	**6.6**	**6.1**	**6.9**	**5.1**
Electricity, gas & water	7.1	6.2	3.7	5.6	4.7
Wholesale & retail trade, hotel & restaurants	25.2	7.8	7.0	8.0	6.1
Government services	12.8	6.7	7.4	7.6	3.7
Other services	13.3	4.7	4.6	4.9	4.6
Total Services	**100.0**	**6.8**	**5.9**	**6.5**	**5.2**

Source: Department of Statistics, Malaysia

Selected Quarterly Indicators in the Services Sector

	2005			2006
	1Q	4Q	Year	1Q
	Annual change (%)			
Total consumption credit outstanding	17.4	18.7	18.7	18.8
Loans outstanding to wholesale & retail trade, hotels & restaurants	12.7	8.3	8.3	7.3
Imports of consumption goods	10.7	4.2	5.9	14.1
Total sales of passenger cars	19.5	13.5	8.6	-9.6
Total sales of commercial vehicles	31.6	16.4	31.2	23.2
Total passenger traffic at all airports	6.6	1.9	4.8	6.5
Cargo handled (all airports)	5.3	6.2	4.3	10.7
Container cargo handled (Port Klang and PTP)	4.7	7.8	4.9	7.8
SMS traffic	70.6	156.3	130.8	118.9
	Percentage (%)			
Cellular phone penetration rate (%)	60.9	74.1	74.1	77.7

Source: Various sources

the telecommunications industry was sustained due to the high level of activity in the cellular segment. The increase in the penetration rate (77.7%; end-2005: 74.1%), and strong growth in SMS traffic exceeding seven billion for two consecutive quarters continued to support growth in the industry. Broadband usage also continued to increase with the number of broadband subscribers exceeding half a million as at end-March 2006 (penetration rate of 2.2%; end-2005: 1.9%).

The **utilities sub-sector** recorded a higher growth of 4.7% (4Q 2005: 3.7%) mainly supported by the increased demand for electricity from the commercial and household users, while growth in the **Government services** sub-sector expanded further due to increase in emoluments and additional allowances paid to civil servants.

Stronger growth in the agriculture sector, while activity in the mining sector remained subdued

Performance in the **primary commodity sector** was mixed in the first quarter of 2006. The agriculture sector recorded a stronger growth of 7.3% (4Q 2005: -1.5%) mainly underpinned by higher activity in the rubber, cocoa, paddy, livestock, fish, fruits and vegetables segments, while crude palm oil production declined during the quarter. Meanwhile, the mining sector continued to decline by 3.5% (4Q 2005: -2%) due to lower production of both crude oil and natural gas.

In the **agriculture sector**, most of the subsectors performed strongly during the quarter. Of significance, **rubber output** turned around to record a significant increase of 25.2% (4Q 2005: -3.8%) despite the wintering season, which occurs during

Performance in the Agriculture Sector

	2005			2006
	1Q	4Q	Year	1Q
	Annual change %)			
Value Added (at 1987 prices)	**6.1**	**-1.5**	**2.5**	**7.3**
Production[1]				
Of which:				
Crude palm oil	27.5	-6.0	7.0	-5.4
Crude palm kernel oil	27.2	-5.4	12.1	-8.9
Rubber	-9.8	-3.8	-3.8	25.2
Fish	-13.0	-1.7	-7.2	8.0
Cocoa	-10.9	-7.8	-16.3	23.2
Exports (RM million)	**6.2**	**3.2**	**3.4**	**5.0**
Of which:				
Palm oil				
('000 tonnes)	13.9	-0.2	10.9	3.5
(RM/tonne)	-15.7	-8.2	-14.6	-4.6
(RM million)	-4.0	-8.4	-5.3	-1.3
Palm kernel oil				
('000 tonnes)	14.5	-2.1	0.0	-30.0
(RM/tonne)	8.3	-12.4	-3.3	-4.7
(RM million)	24.1	-14.2	-3.3	-33.3
Rubber				
('000 tonnes)	-0.8	-0.2	2.1	3.0
(Sen/kilogramme)	-2.2	28.7	9.0	43.7
(RM million)	-2.9	28.4	11.3	48.0
Sawn timber				
('000 cu.metres)	47.8	-0.8	16.4	-21.0
(RM/cu.metre)	-10.3	23.5	8.3	29.8
(RM million)	32.6	22.4	26.0	2.5
Saw logs				
('000 cu.metres)	42.2	1.6	10.6	-19.1
(RM/cu.metre)	4.4	17.0	7.7	17.7
(RM million)	48.4	18.8	19.1	-4.7
Cocoa beans				
('000 tonnes)	183.4	-5.6	-2.1	101.1
(RM/tonne)	0.7	3.5	-1.8	0.1
(RM million)	185.3	-2.3	-3.9	101.2

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

Source: Malaysian Palm Oil Board (MPOB)
Malaysian Rubber Board (MRB)
Fisheries Department, Malaysia
Malaysian Cocoa Board (MCB)
Department of Statistics, Malaysia

February to April that affects yields. The strong performance could be related to the prevailing high prices during the quarter underpinned by strong global demand for natural rubber and further induced by the high synthetic rubber prices in line with the increased crude oil prices during the quarter. Rubber prices strengthened markedly by 47.1% to average 689 sen per kilogram during the quarter (4Q 2005: 605 sen per kilogram), with prices consistently above the 700 sen threshold since February 2006. The high prices had motivated particularly smallholders, that account for almost 95% of Malaysia's natural rubber production, to intensify their tapping activities. The smallholders have also been aided by the mild weather conditions in the rubber producing areas in the northern region of Peninsular Malaysia, compared to the extremely dry weather spell that inhibited latex output in the corresponding period of 2005.

Similarly, output of **cocoa and fish** recorded a strong positive growth in the first quarter of 2006 after recording four consecutive quarter of decline in 2005. Cocoa production rebounded strongly to increase by 23.2% to 9,407 tonnes, in the face of lower incidences of black pod disease that had previously affected yields. Production of fish increased by 8% to 343,108 tonnes, due mainly to the recovery in output of marine fish following initiatives taken by the Government in 2005 to address the problems faced by fishermen in the aftermath of the Tsunami and the increases in petroleum prices. Growth was further reinforced by increased harvest from aquaculture activity, which include ornamental fish, tiger prawns and seaweed.

Meanwhile, production of **crude palm oil** declined by 5.4% to 3.23 million tonnes (4Q 2005: -6%), attributable to lower yields as reflected in the decline in fresh fruit bunches (FFB), as well as oil extraction rates (OER). FFB yields during the quarter declined by 4.4% to 4.14 tonnes per hectare (1Q 2005: 4.33 tonnes per hectare), while the OER dropped slightly to 19.54%, compared to 20.20% recorded in the corresponding period of 2005. Yields during the quarter were affected by excessive rainfall and floods in key producing regions in the west coast of Peninsular Malaysia and Sabah, as well as the prolonged festive holiday period that delayed harvesting activities.

Activity in the **mining sector** was dampened by lower output of crude oil and natural gas. Production of **crude oil** (including condensates) declined by 2.2% to 724,166 barrels per day during the quarter, (1Q 2005: 740,383 barrels per day), while **natural gas** output contracted by 5.9% to 5,974 million standard cubic feet per day (1Q 2005: 6,352 million standard cubic feet per day).

Performance in the Mining Sector

	2005			2006
	1Q	4Q	Year	1Q
	Annual change (%)			
Value Added (at 1987 prices)	**3.4**	**-2.0**	**0.8**	**-3.5**
Production				
Of which:				
Crude oil and condensates ('000 barrels)	-5.2	-3.0	-4.9	-2.2
Natural gas (net) (million standard cubic feet)	19.8	-0.5	11.3	-5.9
Exports (RM million)	**34.8**	**20.2**	**27.1**	**24.0**
Of which:				
Crude oil and condensates				
('000 tonnes)	-1.1	8.6	-2.0	-4.1
(USD/barrel)	36.0	26.3	37.1	41.0
(RM million)	34.5	36.3	33.7	32.6
Liquefied natural gas				
('000 tonnes)	17.6	-1.7	5.9	-2.6
(RM/tonnes)	12.8	17.6	15.0	19.6
(RM million)	32.7	15.5	21.7	16.4

Source: PETRONAS
Department of Statistics, Malaysia

Subdued construction activity

The **construction** sector remained subdued with activity contracting by 1.8% during the quarter (4Q: -0.6%). Growth was mainly affected by the weakness in the civil engineering sector as the main players continued to secure projects abroad in the face of excess capacity in the country. Activity in the residential sub-sector showed signs of moderation as developers became cautious in launching new projects amidst the rising costs and softening demand.

Construction Indicators

	2005			2006
	1Q	4Q	Year	1Q
	Annual change (%)			
New sales and advertising permits	2.3	11.4	15.9	-17.8[1]
Housing approvals	11.2	2.8	-2.7	-43.2[1]
Production of construction-related materials	3.3	-3.8	-0.5	-7.5
Loans approved for construction	47.6	3.4	2.2	-33.6
Imports of construction materials and mineral products	6.1	0.2	-7.3	1.1[1]

[1] Jan-Feb 2006
Source: Ministry of Housing and Local Government and Department of Statistics, Malaysia

Stronger Domestic Demand

Domestic demand growth was stronger in the first quarter of 2006, expanding at an annual rate of 7.6% (4Q 2005: 7.2%). The private sector continued to provide the main impetus to growth.

Private consumption expenditure remained strong in the first quarter, increasing by 7.5%. Despite concerns of rising inflation, consumer spending was supported by continued increases in disposable income amidst sustained high commodity prices and strong export performance. Labour market conditions also remained favourable with job vacancies remaining high while retrenchments declined. Financing conditions also remain supportive of growth. Notwithstanding the increase in Bank Negara Malaysia's Overnight Policy Rate in February, and again in April, interest rates continue to remain below neutral levels and therefore are still supportive of economic activity.

Major consumption indicators also point to sustained consumer spending. Imports of consumption goods and credit card spending registered strong growth, while growth in loans approved and disbursed for consumption purposes was sustained. However, reflecting in part the uncertainties regarding the details of the National Automotive Policy, the number of new passenger cars sold recorded a decline in the first quarter.

Meanwhile, **public consumption** grew by 0.1% as the lower expenditure for supplies of education and health services was more than offset by the higher expenditure on emoluments and defence.

Gross fixed capital formation strengthened further, registering a growth of 11.4%. Investment expenditure was mainly supported by private sector's capital spending, as the Federal Government's development expenditure declined. Spurred by a better business outlook and sustained high capacity utilisation, businesses upgraded and expanded their productive capacity, and undertook new investments in downstream activities. MIER's Business Conditions Index climbed higher to 102.5 points (4Q 2005: 100.5 points), suggesting that manufacturers remained sanguine on sales and production despite higher oil prices. Major investment indicators also pointed to a strong investment pattern. Imports of capital goods and sales of commercial vehicles both recorded strong double-digit growth rates while financial

GDP by Expenditure Components (at Constant 1987 prices)

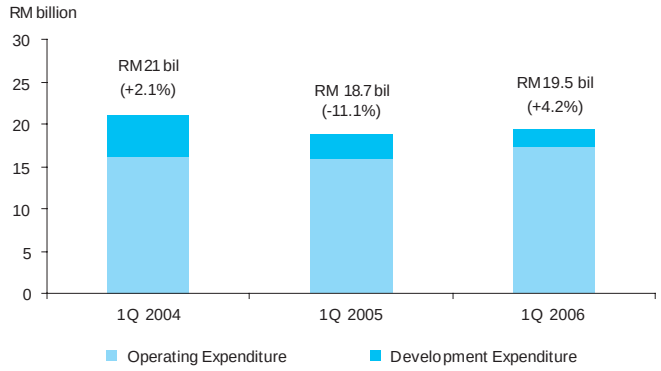
	2005			2006
	1Q	4Q	Year	1Q
	Annual change (%)			
Aggregate Domestic Demand (excluding stocks)	6.4	7.2	7.3	7.6
Consumption	8.3	9.9	8.3	6.1
Private sector	10.1	9.0	9.2	7.5
Public sector	1.0	12.6	5.4	0.1
Gross Fixed Capital Formation	2.0	0.4	4.7	11.4
Exports of Goods and Services	10.8	9.7	8.6	5.9
Imports of Goods and Services	8.4	8.0	8.0	10.8
GDP	**6.1**	**5.2**	**5.2**	**5.3**

Source: Department of Statistics, Malaysia

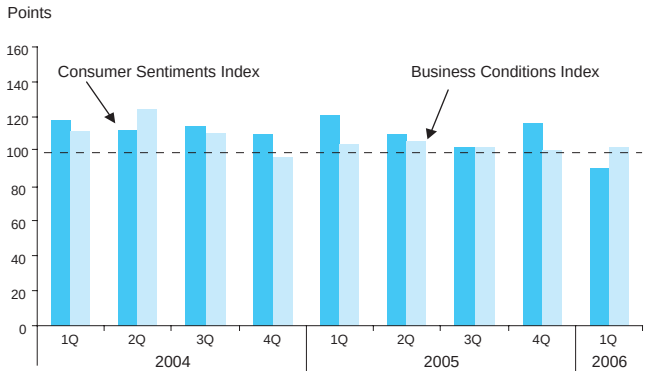
indicators, particularly loans approved and disbursed to businesses, indicated higher investment activities in the first quarter.

The Government's development expenditure, while lower, continued to focus on providing essential services, such as agriculture and rural development, public utilities, education and health services.

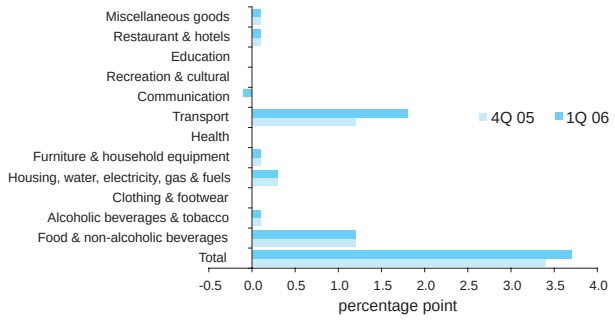
Moderate Increase in Government Spending



Business Confidence Remained High While Consumer Sentiment Declined



Contribution to Consumer Price Inflation



Effective from January 2006, the base reference period for the CPI series is year 2005=100

Inflation increased in the first quarter

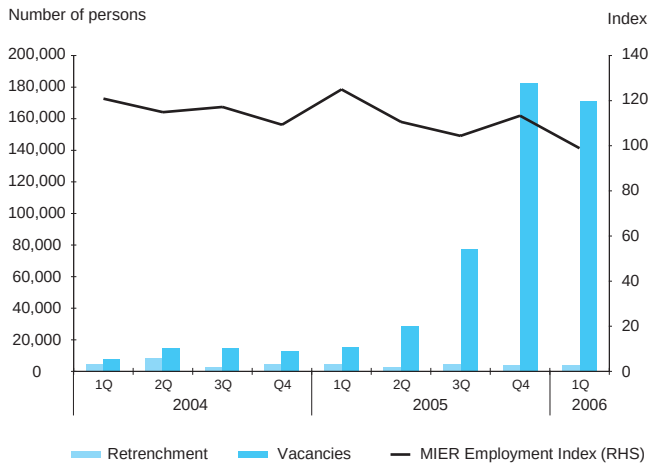
The annual rate of inflation, as measured by the **Consumer Price Index** (CPI), increased to average 3.7% (4Q 2005: 3.4%). This mainly reflected the 18% increase in retail fuel prices on 28 February 2006, resulting in the upward adjustment in the rate of inflation to 4.8% in March.The increase was also in part the result of a higher weight of the transport category in the revised CPI basket (effective from January 2006, the Department of Statistics has revised the CPI base reference period from 2000 to 2005. Please refer to the box article in the Monthly Statistical Bulletin in March 2006 for further details).

The annual rate of increase of the **Producer Price Index** (PPI) increased to 9.9% during the period (4Q 2005: 7.1%). The rise was largely on account of the stronger increase in commodity-related categories amidst higher prices of rubber, crude oil and crude palm oil. Meanwhile, excluding commodities, the rate of increase in the PPI moderated to 0.7% (4Q 2005: 1.7%) due primarily to the slower increase in the PPI for food and live animals and manufacturing-related products, while the PPI for chemical-related products and machinery and transport equipment was lower.

Labour market remained healthy

Labour market conditions continued to be healthy in the first quarter of 2006 as vacancies remained high and both retrenchments and unplaced jobseekers declined further.

Labour Market Conditions



Total vacancies reported during the quarter remained high at 170,882 positions, (4Q 2005: 182,838 positions), with significant numbers of job openings reported in the manufacturing (42%), agriculture (21%) and services (18%) sectors. The sustained strong demand for labour was also reflected in the 23% decline in retrenchments during the quarter, with only 3,648 persons being retrenched during the period (4Q 2005: 3,955 persons). About 34% of the retrenchments affected sales and services workers and some production workers (29%).

The downward trend in retrenchments mirrored the continuing decline in unplaced jobseekers. At end-March 2006, the total number of unplaced jobseekers stood at 56,823, having declined for the seventh successive month since end-September 2005. Most of the jobseekers were school leavers with SPM qualification (32%), degree (24%) and diploma (20%) holders.

Nevertheless, given the greater uncertainty engendered by higher oil prices during the quarter, concerns regarding job prospects heightened during the quarter, as reflected by the weaker MIER Employment Index. It is expected that as the positive trends in the labour market persist over the course of the year, sentiment would similarly pick-up over time.

Real labour productivity, as measured by real sales value of products per employee in the manufacturing sector, declined by 1.1% (4Q 2005: 7.5%), the first quarterly contraction since 1Q 2002 (-3.4%). The decline in real labour productivity growth in the first quarter of this year reflected the lower growth in manufacturing sales on an annual basis amidst higher employment growth and inflation. Real wages, on the other hand, declined more strongly (-1.7%; 4Q 2005: -0.5%) as nominal wages posted a marginal growth, which was more than offset by higher consumer prices.

Exports and imports continued to expand

The trade surplus narrowed to RM25.8 billion in the first quarter of 2006 (4Q 2005: RM28.6 billion) as gross imports grew at a faster pace (13.7%; 4Q 2005: 7.5%) relative to exports (11.5%; 4Q 2005: 12.6%). The strong import growth reflected growth in all categories of imports.

Gross exports grew at a sustained pace of 11.5% in the first quarter of 2006 (4Q 2005: 12.6%) due mainly to strong growth in commodity exports, particularly minerals, and continued double-digit expansion in manufactured exports.

Exports of **manufactured goods** rose by 10.6% (4Q 2005: 13.1%) supported by exports of selected resource-based products and

transport equipment. Meanwhile, exports of E&E products grew, albeit at a more moderate pace of 8.4% (4Q 2005: 14.7%) as robust shipment of computers and computer-related products was offset by slower growth in exports of electrical appliances. Of significance, declining prices of some E&E products amidst the intense competition partly contributed to the lower growth in receipts during the quarter.

Trade Account

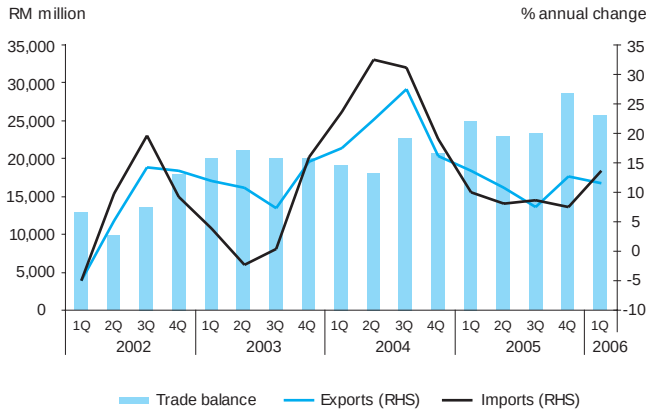
	2005			2006
	1Q	4Q	Year	1Q
	Annual change in (%)			
Gross Exports	**13.7**	**12.6**	**11.0**	**11.5**
Manufacturing	*12.0*	*13.1*	*10.1*	*10.6*
Agriculture	*6.2*	*3.2*	*3.4*	*5.0*
Minerals	*34.8*	*20.2*	*27.1*	*24.0*
Gross Imports	**10.1**	**7.5**	**8.5**	**13.7**
Capital goods	*0.7*	*0.3*	*9.5*	*28.8*
Intermediate goods	*10.6*	*6.3*	*7.2*	*8.0*
Consumption goods	*10.7*	*4.2*	*5.9*	*14.1*
Trade balance (RM bil)	**25.0**	**28.6**	**99.8**	**25.8**

Source: Department of Statistics, Malaysia

Growth in exports of resource-based products was sustained, led mainly by exports of petroleum, rubber products, food and furniture and parts. Exports of petroleum products increased further by 39.3% (4Q 2005: 20.6%), supported by the high prices and robust demand from the regional countries. Similarly, growth in exports of rubber products was sustained at a high level (16.7%; 4Q 2005: 18.7%), due to favourable demand and higher prices as the increase in the cost of raw materials was partially passed on to consumers. Meanwhile, there was a discernible pick-up in exports of furniture and parts (8%; 4Q 2005: 0.8%) supported by favourable demand from the United States, United Kingdom and Australia. Strong growth in exports of floating structures for the oil and gas industry had contributed to the sharp increase (104.9%) in the exports of the transport equipment segment during the quarter.

As a consequence of strong increase in energy prices during the first quarter of 2006, export receipts from **minerals** rose sharply by 24% to RM15 billion, thus achieving the highest ever level on a quarterly basis. Geopolitical uncertainty in major oil producing countries and negligible growth in crude oil supply due to the limited global spare production capacity and inadequate refining capacity in the US amidst the rising demand for petroleum products particularly for transportation purposes had inevitably led to the upward momentum in energy prices. Malaysian crude oil which is of the “light and sweet” variety with low sulphur content was in particular demand from refiners worldwide to produce these transportation-related petroleum products. Consequently, the premium fetched by the Malaysian crude oil over the benchmark grade in the global oil markets increased resulting in the Malaysian export prices to average USD65.32 per barrel. In line with the higher energy prices, proceeds from exports of liquefied natural gas (LNG) also rose by 16.4%, driven entirely by a substantial increase in prices (19.6%) to an average of RM1,041 per tonne.

Trade Balance



Malaysia: Direction of Exports

	2005			2006	2005			2006	2005			2006
	1Q	4Q	Year	1Q	1Q	4Q	Year	1Q	1Q	4Q	Year	1Q
	RM billion				Share of total exports (%)				Annual change (%)			
United States	**21.6**	**27.5**	**105.0**	**24.5**	**17.6**	**19.3**	**19.7**	**17.9**	**12.2**	**18.8**	**16.5**	**13.4**
European Union (EU)	**14.6**	**17.5**	**62.6**	**16.1**	**11.9**	**12.3**	**11.7**	**11.8**	**5.3**	**11.2**	**3.7**	**10.0**
Selected ASEAN countries[1]	**32.6**	**36.7**	**137.8**	**37.4**	**26.6**	**25.7**	**25.8**	**27.3**	**20.9**	**14.5**	**15.1**	**14.7**
North East Asia	**23.5**	**27.0**	**99.2**	**25.2**	**19.2**	**18.9**	**18.6**	**18.4**	**7.3**	**11.0**	**6.2**	**7.2**
People's Republic of China	*8.0*	*10.5*	*35.2*	*8.3*	*6.5*	*7.3*	*6.6*	*6.1*	*10.8*	*26.2*	*9.6*	*4.4*
Hong Kong China	*7.1*	*7.8*	*31.2*	*7.5*	*5.8*	*5.5*	*5.8*	*5.5*	*9.7*	*6.5*	*8.8*	*6.2*
Chinese Taipei	*3.1*	*4.0*	*14.8*	*3.3*	*2.5*	*2.8*	*2.8*	*2.4*	*-14.4*	*-2.4*	*-6.0*	*7.2*
Korea	*5.4*	*4.7*	*17.9*	*6.1*	*4.4*	*3.3*	*3.4*	*4.5*	*14.9*	*2.5*	*6.6*	*12.8*
India	**3.7**	**4.2**	**15.0**	**4.0**	**3.0**	**2.9**	**2.8**	**2.9**	**37.0**	**32.2**	**31.2**	**8.3**
Total exports	**122.6**	**142.6**	**533.8**	**136.7**	**100.0**	**100.0**	**100.0**	**100.0**	**13.7**	**12.6**	**11.0**	**11.5**

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

Agriculture exports continued to increase further by 5% during the quarter to RM9.2 billion (4Q 2005: 3.2%), mainly supported by the substantial rise in rubber exports of 48% (4Q 2005: 28.4%). The exceptional performance was attributable to the strong increase in export prices (43.7% to 666 sen per kilogramme; 4Q 2005: 28.7%) induced by the high global demand for natural rubber from the automotive sector, coupled with the rise in prices of the competing synthetic rubber, a petrochemical product, which has been rising in tandem with the stronger crude oil prices. These developments had led to depleting global rubber stocks, which exerted upward pressure on prices. Meanwhile, palm oil exports declined by 1.3% during the quarter (4Q 2005: -8.4%) due entirely to lower prices, while export volume continued to rise by 3.5%. Export prices, although remaining attractive at RM1,420 per tonne in the first quarter, was still lower than the level recorded in the corresponding period of 2005. Meanwhile, shipments to the main export markets including PR China, the Middle East and the US continued to increase.

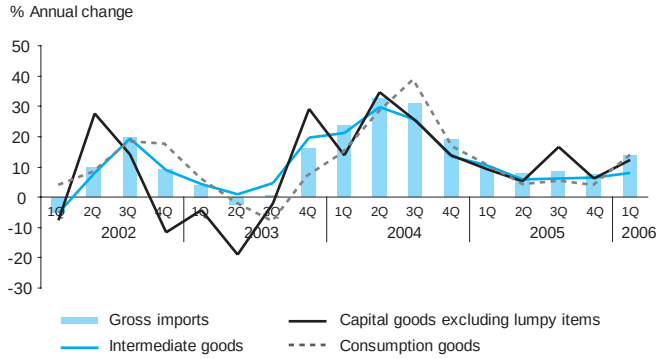
Malaysia's trade with major trading partners continued to grow. Exports to regional countries (excluding Japan) expanded by 11.6% to account for a higher share of 45.8%. Growth in regional exports was driven by Singapore, Vietnam and Korea. Exports to Singapore were supported by strong demand for electronics and electrical (E&E) products, refined petroleum products, transport equipment and crude petroleum while Korea continued to source LNG, crude petroleum and chemicals from Malaysia. Of significance, exports to Vietnam grew by 107%, underpinned by exports of transport equipment, palm oil, manufactures of plastics and metal.

During the quarter, Malaysia also recorded strong export growth to the US, EU, Australia and New Zealand. Exports to the US were led by exports of E&E and wood products, textiles and clothing, rubber products and palm oil. In line with improvements in economic activity, exports to the EU countries recorded growth of 10%. Exports to Australia and New Zealand were supported by strong demand for crude petroleum and E&E products.

On the imports side, Malaysia continued to source imports of components from regional countries, particularly Singapore, PR China, Thailand and Korea. Imports from the regional countries grew strongly by 14.2%, reflecting mainly imports of E&E products, chemicals and manufactures of metal. Imports from the US expanded by 26.4% accounting for a higher share of 14% of imports underpinned by high imports of E&E products, transport equipment as well as optical and scientific equipment.

Gross imports strengthened by 13.7%, reflecting strong private investment activity and domestic consumer spending as well as

Import Growth



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

	2005			2006
	1Q	4Q	Year	1Q
	Annual change (%)			
CAPITAL GOODS	**0.7**	**0.3**	**9.5**	**28.8**
Capital goods (except transport equipment)	7.3	5.3	10.0	17.2
Transport equipment	-43.0	-26.8	5.3	173.3
INTERMEDIATE GOODS	**10.6**	**6.3**	**7.2**	**8.0**
Food and beverages, mainly for Industry	-7.9	6.9	-5.6	29.0
Industrial supplies, n.e.s.	16.0	0.6	6.0	1.3
Fuel and lubricants	95.7	32.2	42.3	21.1
Parts and accessories of capital goods (except transport equipment)	0.1	5.6	2.7	8.9
Parts and accessories of transport equipment	40.9	11.3	34.8	9.4
CONSUMPTION GOODS	**10.7**	**4.2**	**5.9**	**14.1**
Food and beverages, mainly for household consumption	9.5	-1.2	4.0	3.6
Transport equipment, non-industrial	-16.2	17.5	-4.9	23.5
Consumer goods, n.e.s.	12.2	7.4	7.4	20.9
Durables	*11.3*	*12.3*	*12.3*	*32.3*
Semi-durables	*3.4*	*5.1*	*0.4*	*27.3*
Non-durables	*19.2*	*6.5*	*10.2*	*11.3*
DUAL USE GOODS	**17.0**	**12.2**	**21.5**	**23.2**
OTHERS	**-6.0**	**4.9**	**0.8**	**12.0**
RETAINED IMPORTS	**9.0**	**5.4**	**7.7**	**11.7**
RE-EXPORTS	**35.3**	**53.4**	**26.9**	**52.3**
GROSS IMPORTS	**10.1**	**7.5**	**8.5**	**13.7**

Source: Department of Statistics, Malaysia

continued expansion in inputs for manufactured exports. Imports of **intermediate goods,** particularly inputs for the E&E products, grew by 8%. Higher demand for festivities also induced the increase in imports of food and beverages. Imports of fuel and lubricants recorded strong growth during the quarter, underpinned by high oil prices.

A notable feature was the significant growth of 28.8% in **capital goods** to RM15.9 billion. Imports of capital goods excluding lumpy items increased by 12.3%. The increase in imports for capacity expansion and upgrading of technology occurred in the manufacturing and services sectors, as evidenced by the increase in imports of machinery for manufacturing, metal tools, office equipment and generators, turbines and electric motors. Increased exploration and development activity in the upstream oil and gas industry also led to higher imports of construction and mining equipment. Strong external demand for commodity exports and expansion in intra-regional travel led to an increase in deliveries of ships, aircraft and rail locomotives. In line with sustained private consumer spending, imports of **consumption goods** increased by 14.1%. Consumption imports mainly comprised the imports of durable and semi-durable consumer goods.

Continued inflows of FDI

On a cash basis, gross inflows of **foreign direct investment (FDI)** amounted to RM3.7 billion (4Q 2005: RM13 billion), reflecting mainly lower extension of short-term inter-company loans by foreign MNCs to their subsidiaries in Malaysia. The bulk of the gross inflows were in the form of equity capital and channelled into the services, manufacturing and oil and gas sectors. In the services sector, FDI inflows were mainly concentrated in the financing, insurance and business services as well as restaurants, hotels, wholesale and retail trade sub-sectors. Meanwhile, inflows of FDI into the manufacturing sector were directed primarily into the electrical and electronics, petroleum-related as well as optical goods industries. After adjustments for outflows due mainly to repayments of short-term loans to related companies, FDI recorded a net inflow of RM0.9 billion (4Q 2005: RM2.9 billion). The FDI on cash basis does not include retained earnings and investment in the form of imported machinery and equipment.

Overseas investment recorded a significantly higher gross outflow of RM47.9 billion (4Q 2005: RM18.1 billion) due entirely to marked increase in the short-term loan extensions by non-resident controlled companies in the oil and gas sector to their related companies abroad arising from their centralised treasury operations. These outflows were largely offset by inflows arising from repayment of short-term inter-company loans during the quarter. After adjusting mainly for these inflows, overseas investment recorded a net outflow of RM1.8 billion (4Q 2005: +RM1.9 billion). The investments were led by companies in the services sector, particularly in the utilities sub-sector following the acquisition of a power generating company in Egypt, as well as in the financing, insurance and business services sub-sector. Meanwhile, companies in the manufacturing sector continued to invest abroad, primarily in the electrical and electronics and chemical-related products industries.

Portfolio investment recorded a net inflow of RM3.9 billion (4Q 2005: -RM13.7 billion), reflecting renewed foreign interest, particularly in the debt securities.

External debt declined

Malaysia's total external debt declined to RM191 billion or USD51.3 billion as at end-March 2006 (end-2005: RM195.9 billion or USD51.3 billion), equivalent to 36.8% of GNP. The improvement in the external debt position was attributed to declines in both the medium- and long-term and short-term external debt. The lower **medium- and long-term external debt** (RM147.7 billion; end-2005: RM149 billion), reflected mainly the exchange revaluation gain following the appreciation of the ringgit against major currencies, particularly the US dollar. During the quarter, both the Federal Government and the private sector recorded a small net repayment of external loans.

Meanwhile, the non-financial public enterprises (NFPEs), which had recorded six consecutive quarters of net repayments, reversed to register a net drawdown of external loans (RM3 billion). The drawdown of external loans was mainly to finance capital expenditure, working capital requirement and repayments of offshore loans, particularly by transportation companies.

The total **short-term external debt** declined to RM43.3 billion or USD11.6 billion (end-2005: RM46.8 billion), reflecting lower short-term borrowings by both the banking and non-bank private sectors. As at end-March 2006, the short-term debt accounted for only 22.7% of total external debt and is 16% of the net international reserves.

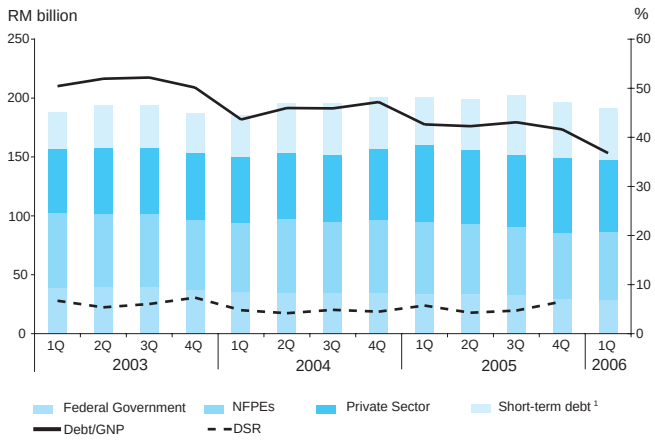
External Debt Outstanding

	2005		2006
	1Q	4Q	1Q [p/]
	RM billion		
Medium- and Long-term debt	160.1	149.0	147.7
Public sector	94.7	86.1	86.8
Private sector	65.4	62.9	60.9
Short-term debt[1]	40.5	46.8	43.3
Total external debt	200.6	195.9	191.0
- USD billion equivalent	52.8	51.3	51.3

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

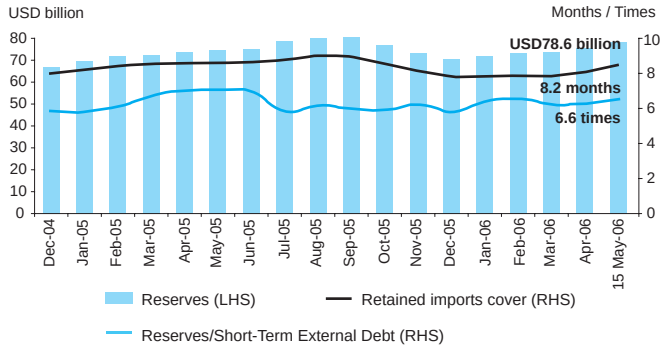
Source: Ministry of Finance, Malaysia and Bank Negara Malaysia

External Debt Outstanding

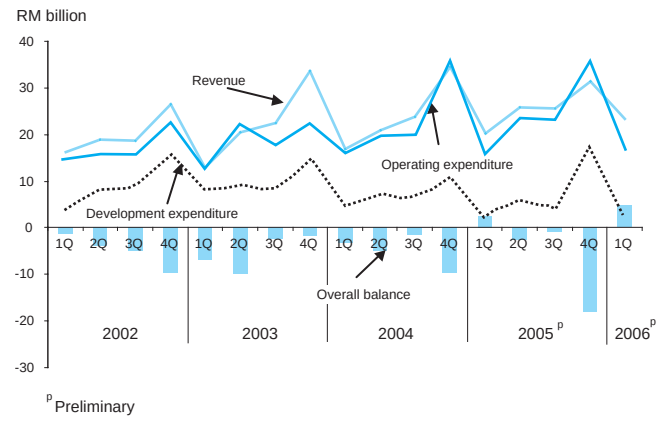


[1] Excludes currency and deposits held by non-residents with resident banking institutions

Net International Reserves (as at end-period)



Federal Government Finance



Federal Government Finance[p]

	2005			2006
	1Q	4Q	Year	1Q
	RM billion			
Revenue	21.1	32.2	106.3	24.2
% growth	*19.2*	*-8.7*	*6.9*	*14.5*
Operating expenditure	15.9	35.5	97.7	17.3
% growth	*-1.5*	*-0.2*	*7.1*	*8.9*
Current account	**5.2**	**-3.3**	**8.6**	**6.9**
% of GDP	***4.5***	***-2.5***	***1.7***	***5.3***
Gross development expenditure	2.8	17.5	30.5	2.1
% growth	*-42.9*	*66.5*	*5.8*	*-23.0*
Overall balance	**2.6**	**-17.9**	**-18.7**	**4.9**
% of GDP	***2.3***	***-13.7***	***-3.8***	**3.8**
Memo item:				
Total gross expenditure	18.7	52.9	128.3	19.5
% growth	*-11.1*	*15.0*	*6.8*	4.2
Total Federal Government debt (as at end-period)	223.1	228.7	228.7	232.2
% of GDP	*45.0*	*46.2*	*46.2*	*42.8*
Domestic debt	189.3	198.7	198.7	203.3
% of GDP	*38.2*	*40.1*	*40.1*	*37.5*
External debt	33.8	30.0	30.0	28.9
% of GDP	*6.8*	*6.1*	*6.1*	*5.3*

[p] Preliminary

Higher international reserves

The international reserves of Bank Negara Malaysia amounted to RM271.6 billion or equivalent to USD73.7 billion as at 31 March 2006. 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 increased further to RM289.5 billion or equivalent to USD78.6 billion as at 15 May 2006. The reserves position is sufficient to finance 8.2 months of retained imports and is 6.6 times the short-term external debt.

Improved Fiscal Position

Stronger revenue collection which more than offset the increase in total expenditure resulted in larger fiscal surplus of RM4.9 billion or 3.8% of GDP in the first quarter of 2006. Higher receipts were mainly from petroleum-based revenue coupled with payments of income taxes by individual and corporation. Total expenditure rose at an annual rate of 4.2%, due to higher operating expenditure reflecting the annual grant to the Pension Trust Fund and higher debt servicing. Funds were raised entirely from domestic sources. As at end-March 2006, total outstanding debt of the Federal Government amounted to RM232.2 billion or 42.8% of GDP. The external debt of the Federal Government continues to remain low at 5.3% of GDP.

MONETARY AND FINANCIAL DEVELOPMENTS

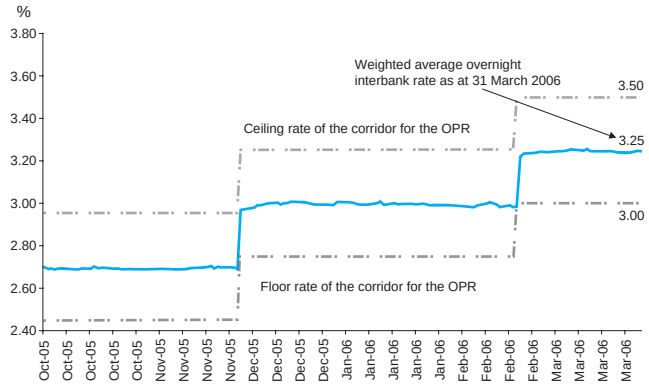
Interest rates rose following the increase in the OPR

In the first quarter of 2006, economic indicators continued to point toward sustained economic growth, supported by sustained private sector demand and strong economic growth in the global and regional economies. The rate of inflation was, however, expected to remain at an elevated level for some time. Thus, to align the interest rates to current economic conditions, the Overnight Policy Rate (OPR) was raised by 25 basis points to 3.25% on 22 February 2006 and by another 25 basis points to 3.50% on 26 April 2006. Despite these two increases, interest rates continue to remain below the neutral level and thus, monetary policy continued to remain supportive of economic activity.

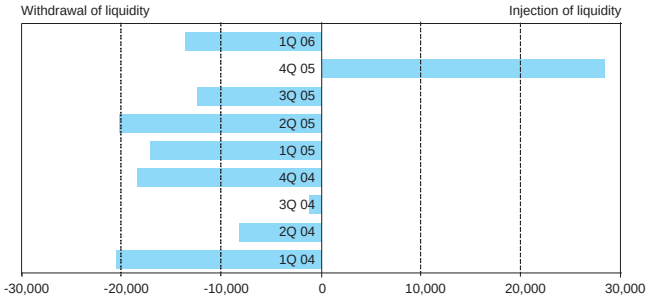
The daily weighted average overnight interbank rate moved within a range of 2.98% – 3.25% during the first quarter of 2006 (4Q 2005: 2.69% – 3.01%). Interbank rates of other maturities also rose by 22 to 24 basis points. Following the increase in the OPR on 26 April 2006, the daily weighted average overnight interbank rate moved within a range of 3.46% – 3.50% during the period 27 April to 26 May 2006, while interbank rates of other maturities rose by 30 to 37 basis points during this period.

In terms of retail interest rates, the average base lending rate (BLR) of commercial banks (CBs) increased to 6.47% at end-March 2006 (4Q 2005: 6.20%), as all CBs adjusted their BLRs upward. The average lending rate (ALR) of CBs rose to 6.29% (4Q 2005: 6.12%). At end-April 2006, the average BLR and ALR of CBs were 6.58% and 6.42% respectively.

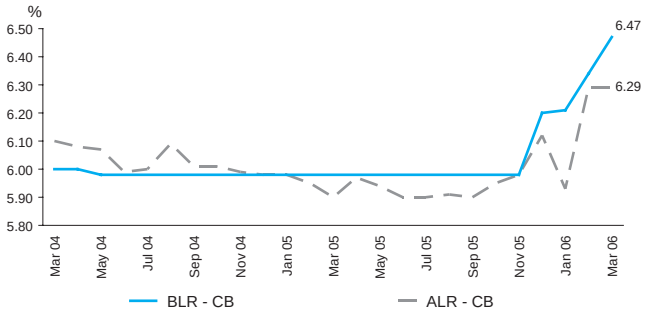
Daily Weighted Average Overnight Interbank Rate



BNM Liquidity Operations
(During the quarter, RM m)



Lending Rates of Commercial Banks
(average for the period)



Interest Rates

	2005		2006
	1Q	4Q	1Q
	At end-period (%)		
Overnight Policy Rate (OPR)	2.70	3.00	3.25
Interbank rates			
Overnight	2.72	3.00	3.25
1-month	2.77	3.12	3.25
Base lending rates (BLR)			
Commercial banks	5.98	6.20	6.47
Average lending rates (ALR)			
Commercial banks	5.90	6.12	6.29
Fixed deposit rates			
Commercial banks			
3-month	3.00	3.02	3.06
12-month	3.70	3.70	3.70

modest pace of M3 growth mainly reflected the slower rate of increase in net external operations. Nonetheless, during the first quarter of 2006, M3 increased further with the expansion of net external operations. Both claims on the private sector and net claims on the Government were also expansionary on M3. In the case of claims on the private sector, the sustained increase in banking system's loans outstanding was partly offset by the lower holding of securities by the banking system.

The average quoted fixed deposit (FD) rates of CBs for the 1-month to 9-month maturities edged upwards to between 3.03% and 3.16% as at end-March 2006 (4Q 2005: 3.01% and 3.08%), while the average rate at the 12-month maturity remained unchanged at 3.70%. By 15 May 2006, the average FD rates for CBs for the 1-month to 12-month maturities had edged up to between 3.11% and 3.73%. In particular, the increase was evident in FD rates for the 6-month and 9-month maturities, which increased to 3.31% and 3.43% respectively (4Q 2005: 3.04% and 3.08% respectively).

Monetary aggregates expanded at more moderate growth rates

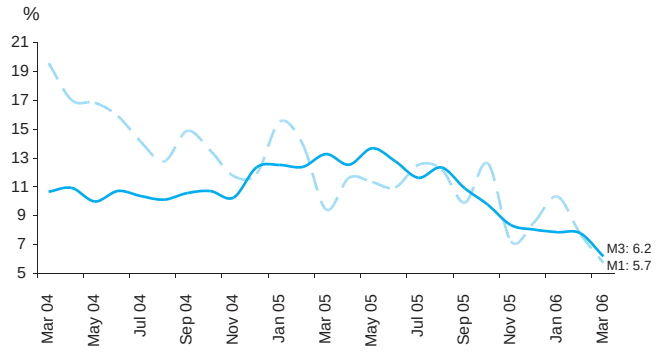
M1 or narrow money, expanded at an annual rate of 5.7% (4Q 2005: 8.5%) at the end of the first quarter, while M3 or broad money increased by 6.2% (4Q 2005: 8%). The more

M3 Determinants

	2005			2006
	1Q	4Q	Year	1Q
	RM billion			
M3	26.4	10.8	49.7	16.5
Net claims on Government	-9.1	12.6	-5.5	2.8
Claims on private sector	8.2	14.2	44.6	4.9
Net external operations[1]	29.0	-23.8	16.5	13.8
Other influences	-1.8	7.7	-6.0	-5.0

[1] Pre-revaluation

Monetary Aggregates: Annual Change



Private sector financing activity remained high

In the first quarter of 2006, gross financing to the private sector from the banking system and the capital market amounted to RM138.3 billion, expanding at an annual rate of 3.3% (4Q 2005: RM151.1 billion; +7.8%). On a quarterly basis, financing was lower compared to the seasonally high level recorded in the fourth quarter. On a net basis, financing of the private sector through banking system loans and PDS outstanding expanded at a combined annual rate of 9.1% (4Q 2005: 9.3%).

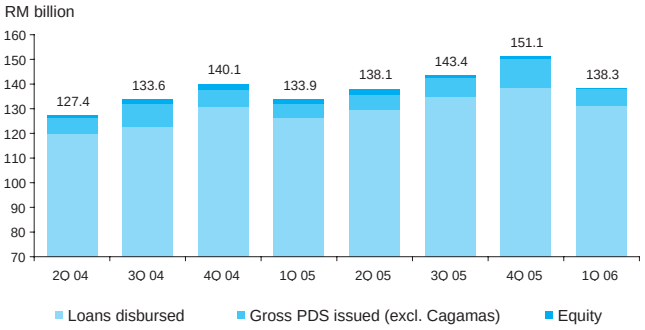
On an aggregate basis, the major loan indicators registered higher levels compared with the corresponding quarter in 2005. In the business sector, loan applications and approvals were sustained, particularly for large corporations. Loan disbursements to businesses continued to be channelled mainly to the manufacturing (33.9% of total loans disbursed to businesses); wholesale and retail trade, restaurants and hotels (27%); finance, insurance

Financing of the Private Sector through Banking System and Capital Market

	During the period (RM billion)				Annual growth (%)		
	2005	1Q 05	4Q 05	1Q 06	2005	4Q 05	1Q 06
Gross total financing	566.4	133.9	151.1	138.3	8.9	7.8	3.3
Loans disbursed *	529.3	126.6	138.3	131.1	8.4	5.8	3.5
Gross PDS (excl. Cagamas)	30.8	5.3	11.7	6.9	20.3	67.1	30.3
Equity	6.3	2.0	1.0	0.4	-2.5	-55.0	-81.0
Outstanding total financing (A)+(B)	62.2	11.1	17.4	11.1	9.3	9.3	9.1
Banking system	46.3	8.1	13.5	9.9	8.5	8.5	8.7
Loans outstanding (A)	44.2	8.6	10.1	8.2	8.6	8.6	8.4
Holding of PDS	2.1	-0.6	3.5	1.6	6.3	6.3	13.2
PDS outstanding (B)	18.0	2.5	7.3	2.9	11.4	11.4	11.5
Memorandum item							
Gross PDS (incl. Cagamas)	15.2	5.5	15.2	10.6	-58.3	50.4	92.7

* 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
	2005	1Q 05	4Q 05	1Q 06		
	RM billion			%		
Business enterprises	360.1	86.9	94.2	88.3	67.4	39.7
*Large corporations **	*249.5*	*61.0*	*65.0*	*59.3*	*45.3*	*21.8*
*SMEs **	*110.7*	*25.9*	*29.2*	*29.0*	*22.1*	*17.9*
Households	145.2	33.9	37.6	35.3	26.9	55.2
By sector						
Agriculture, hunting, forestry and fishing	13.8	3.1	3.6	3.0	2.3	2.0
Mining and quarrying	1.6	0.5	0.4	0.6	0.4	0.2
Manufacturing	127.0	30.9	31.8	30.0	22.9	10.9
Broad property sector	92.6	22.0	24.0	22.6	17.3	41.1
Construction	*30.4*	*7.4*	*7.7*	*7.4*	*5.7*	*5.2*
Purchase of residential property	*38.5*	*9.2*	*9.7*	*9.0*	*6.9*	*27.0*
Purchase of non-residential property	*14.7*	*3.5*	*3.9*	*3.5*	*2.6*	*6.3*
Real estates	*9.0*	*1.9*	*2.6*	*2.7*	*2.1*	*2.6*
Electricity, gas and water supply	7.1	1.4	1.9	1.8	1.3	0.9
Wholesale, retail, restaurants and hotels	97.5	22.3	25.5	23.8	18.2	8.3
Transport, storage and communication	9.8	1.9	2.4	2.7	2.0	1.8
Finance, insurance and business services	35.7	11.1	9.8	9.5	7.3	5.7
Consumption credit	100.8	23.0	26.5	24.5	18.7	22.4
Of which:						
Credit cards	*42.7*	*10.0*	*11.7*	*11.4*	*8.7*	*3.0*
Purchase of passenger cars	*39.2*	*8.6*	*10.0*	*8.2*	*6.3*	*15.8*
Purchase of securities	11.7	3.2	3.0	3.4	2.6	3.7
Purchase of transport vehicles excluding passenger cars	0.7	0.2	0.1	0.2	0.1	0.4
Others	31.1	6.9	9.4	9.0	6.9	2.7
Total	**529.3**	**126.6**	**138.3**	**131.1**	**100.0**	**100.0**

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

Source: Bank Negara Malaysia

Loan Indicators

	During the period (RM billion)				Annual Growth %			
	2005	1Q 05	4Q 05	1Q 06	2005	1Q 05	4Q 05	1Q 06
Total								
Loan applications	305.4	68.4	72.1	70.2	11.7	16.9	6.4	2.7
Loan approvals	192.2	42.7	47.7	45.5	10.7	14.8	10.4	6.7
Loan disbursements	529.3	126.6	138.3	131.1	8.4	10.2	5.8	3.5
Loan repayments	489.2	117.9	129.2	121.6	6.0	4.8	7.1	3.1
Change in loan outstanding*	44.2	8.6	10.1	8.2	8.6	9.1	8.6	8.4
Of which:								
Business enterprises								
Loan applications	158.5	36.3	36.7	36.3	5.7	19.0	-2.0	-0.1
Loan approvals	92.0	20.1	23.6	21.5	8.4	16.7	9.2	7.1
Loan disbursements	360.1	86.9	94.2	88.3	7.4	11.1	3.7	1.6
Loan repayments	343.7	82.6	91.9	83.6	7.5	9.3	8.7	1.2
Change in loan outstanding*	6.5	-0.1	-0.9	-0.7	3.0	2.8	3.0	2.7
SMEs**								
Loan applications	59.7	13.1	12.9	10.9	10.3	24.4	-7.2	-17.0
Loan approvals	34.5	8.1	7.5	7.5	9.2	42.0	-14.1	-8.3
Loan disbursements	110.7	25.9	29.2	29.0	10.2	9.6	7.5	11.8
Change in loan outstanding*	7.7	1.2	1.5	5.2	8.7	10.5	8.7	13.2
Large corporations**								
Loan applications	98.8	23.2	23.8	25.4	3.2	16.2	1.1	9.3
Loan approvals	57.5	12.0	16.2	14.1	8.0	4.0	24.9	17.6
Loan disbursements	249.5	61.0	65.0	59.3	6.2	11.7	2.1	-2.7
Change in loan outstanding*	-1.2	-1.2	-2.4	-5.9	-0.9	-2.0	-0.9	-4.5
Households								
Loan applications	141.9	31.0	34.6	31.4	18.0	14.0	18.3	1.0
Loan approvals	97.2	21.9	23.4	21.6	12.0	13.3	9.7	-1.0
Loan disbursements	145.2	33.9	37.6	35.3	11.4	10.0	10.8	4.1
Loan repayments	115.1	28.1	29.9	30.7	7.6	4.6	7.3	9.3
Change in loan outstanding*	40.0	8.7	10.7	8.4	15.1	15.2	15.1	14.5

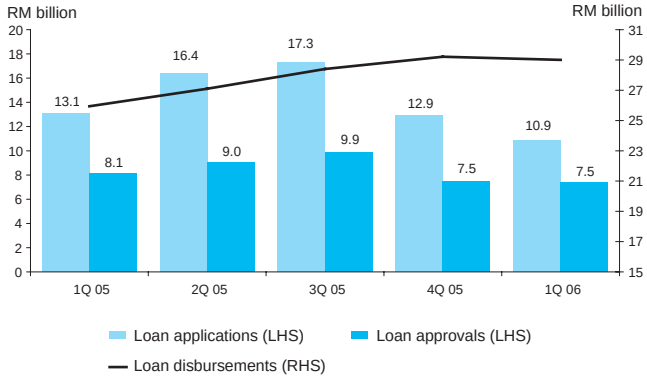
* The annual growth is for end-period.
** In 1Q 2006, loan indicators for SMEs and large corporations are not comparable on an annual and preceding quarter basis as beginning March 2006, financial institutions have begun adopting the Standard SME Definitions as approved by the National SME Development Council, resulting in some reclassification between SMEs and large corporations.

Source: Bank Negara Malaysia

and business services (10.8%); and construction (8.4%) sectors. At the end of first quarter 2006, total loans outstanding to businesses increased at an annual rate of 2.7%, while NPLs as a percentage of loans outstanding to businesses continued to decline, to 11% (end-4Q 2005: 11.2%).

In the household sector, with the exception of loan approvals which recorded slightly lower levels than that recorded in the first quarter 2005, other loan indicators recorded higher levels. Loan disbursements to households were driven mainly by

Bank Lending to SMEs

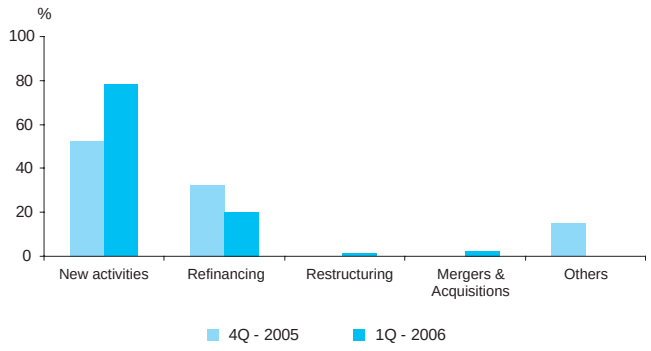


Funds Raised in the Capital Market

	2005			2006
	1Q	4Q	Year	1Q
	RM million			
By Public Sector				
Government Securities, *gross*	4,000	6,500	28,276	5,265
Less Redemptions	-	4,850	15,800	500
Less Government holdings	-	-	-	-
Equals Net Federal receipts	4,000	1,650	12,476	4,765
Khazanah Bonds, *net*	833	-	833	(1,700)
Govt. Investment Issues, *net*	2,000	(1,000)	1,000	-
Merdeka Savings Bond, *net*	357	397	1,516	(500)
Net Funds Raised	7,190	1,047	15,825	2,564
By Private Sector				
Shares	2,009	1,043	6,315	381
Debt securities	5,486	15,161	38,196	10,574
Private Debt Securities (PDS)	5,286	13,801	35,656	6,889
Cagamas	200	1,360	2,540	3,685
Less Redemptions	4,212	4,701	18,617	5,499
Net Issues	1,274	10,461	19,579	5,075
Net issues (excluding Cagamas)	2,634	9,851	22,224	2,992
Net Funds Raised	3,282	11,504	25,894	5,456
Total Net Funds Raised	10,473	12,552	41,719	8,021
Short-term Papers and Notes, *net* [1]	587	456	1,579	1,312
Total	11,059	13,008	43,297	9,333

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

Private Debt Securities Issued by Purpose (% of total)



Capital market remained an important source of financing

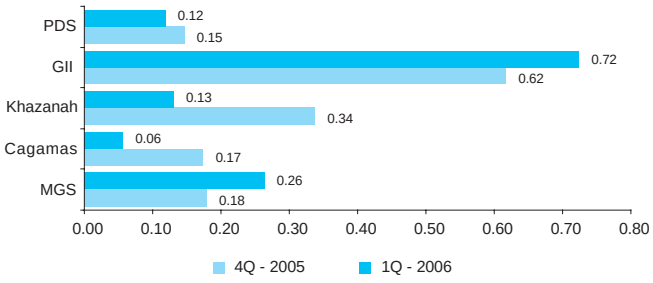
The capital market remained a vital source of financing to the economy, mobilising net funds of RM8 billion during the first quarter of 2006 (4Q 2005: RM12.6 billion), with the bulk of the financing raised from the bond market.

In the private debt securities (PDS) market, gross financing amounting to RM10.6 billion were raised by 25 corporations, mainly from construction and services sectors. Excluding Cagamas, the funds raised were mainly channeled to finance new activities (78.2% of new issuances) and refinancing existing debt (20.3% of new issuances). After adjusting for redemptions of RM5.5 billion, net funds raised through the PDS market amounted to RM5.1 billion (4Q 2005: RM10.5 billion).

Funds raised through the equity market during the first quarter amounted to RM381 million. The bulk of the funds was raised through eight initial public offerings (IPOs) totaling RM306 million. During the quarter, eight new companies were listed on Bursa Malaysia. Of these eight companies, one was listed on the Second Board and seven on the MESDAQ Market.

credit card spending (32.3% total loans disbursed to households); purchase of residential properties (25.7%); and purchase of passenger cars (23.4%). Loans outstanding to households increased by 14.5% on an annual basis. Meanwhile, the ratio of NPLs to household loans outstanding remained stable at 7.4% at end-1Q 2006 (end-4Q 2005: 7.5%).

Liquidity Ratio: Turnover / Outstanding



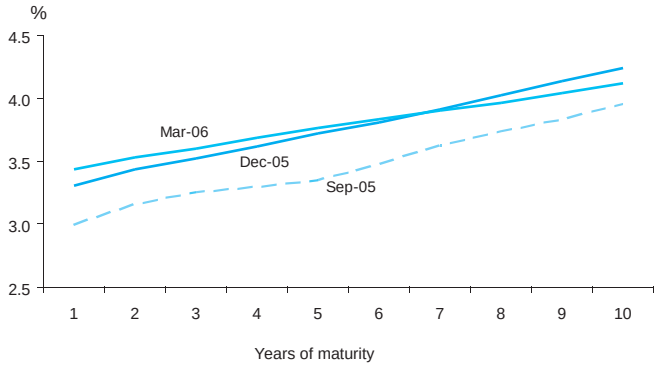
The Government raised a gross total of RM5.3 billion via two reopening of Malaysian Government Securities (MGS) and one issuance of 10-year MGS. On a net basis, funds raised by the public sector were higher during the quarter amounting to RM2.6 billion (4Q 2005: RM1.0 billion).

Higher secondary trading in the bond market

In the secondary market, total turnover increased to RM75.5 billion in the first quarter (4Q 2005: RM69.9 billion). Government Securities accounted for 69% of the total trade, followed by total private debt securities which contributed 27.4% of the total trade. In terms of liquidity, the GII and MGS bonds were the most liquid papers, registering liquidity ratios of 0.72 and 0.26 respectively.

Throughout the first quarter of 2006, sentiments in the bond market were affected by the anticipation of further increases in the interest rate amidst higher inflation.The shorter-end of the MGS benchmark yields moved upwards since February, reflecting market expectations of higher interest rates. In addition, the yields were also influenced by the increase in the US Treasury yields following the increases in the Federal Fund rates. On the other hand, the longer-end of the curve flattened slightly as the demand for the new 10-year MGS issuance was relatively higher than the available new issuance. As a result, the 10-year MGS benchmark yield declined by 12 basis points during the quarter.

Trend in MGS Yield



Bursa Malaysia: Turnover of Corporate Securities

	2005						2006	
	1Q		4Q		Year		1Q	
	million units	RM million	million units	RM million	million units	RM million	million units	RM million
Turnover	30,042	56,261	18,541	35,264	102,338	177,321	45,988	53,671
of which:								
Main Board	21,236	48,384	13,788	32,391	73,816	157,445	26,565	42,744
of which								
Consumer Products	1,018	3,117	647	1,863	3,694	10,197	1,808	4,834
Industrial Products	4,829	5,767	1,633	2,020	12,150	14,143	3,147	3,133
Construction	1,579	3,114	694	1,067	4,141	7,116	3,048	3,120
Trading/Services	4,320	15,710	3,321	12,417	16,008	59,241	6,191	14,985
Finance	3,059	10,495	2,262	8,796	10,108	36,743	2,711	9,046
Properties	3,367	5,602	1,392	1,236	10,649	11,572	4,106	2,040
Plantations	604	2,168	539	2,762	2,144	9,147	518	2,708
Mining	0	1	0	1	0	10	0	1
Second Board	5,537	5,586	1,708	1,175	15,161	12,289	5,837	4,532

Source: Bursa Malaysia

KLCI performance showed improvement

Market sentiment improved despite concerns over increasing global prices of crude oil and domestic inflation. Steady support from both local and foreign institutions provided further strength to the market. During the quarter under review, the KLCI increased by 26.84 points (4Q 2005: -27.75 points), ending the quarter higher at 926.63 (4Q 2005: 899.79). Market capitalisation was also higher at RM732.9 billion (4Q 2005: RM695.3 billion). Trading activity increased and recorded a higher average daily turnover, at 779.5 million units during the quarter (4Q 2005: 303.9 million units).

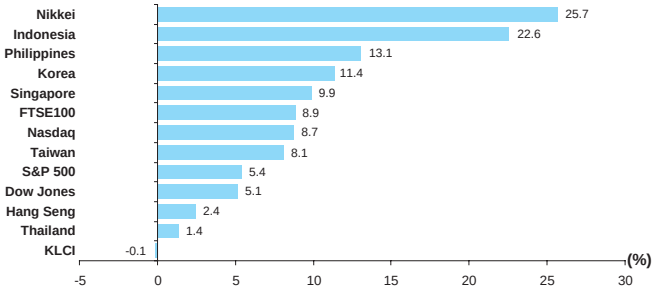
As at 26 May 2006, the KLCI closed higher at 930.75 (since end-December 2005: +3.4%) with market capitalisation increasing to RM732.83 billion (since end-December 2005: +5.4%).

Bursa Malaysia: Selected Market Indicators

	As at end			
	2005			2006
	1Q	4Q	Year	1Q
Price Indices				
Composite	871.35	899.79	899.79	926.63
EMAS	204.98	203.85	203.85	213.36
Second Board	101.76	80.44	80.44	91.14
Average daily turnover				
Volume (million units)	509.19	303.94	414.33	779.45
Value (RM million)	949.41	578.09	716.91	909.67
Market capitalisation (RM b)	694.89	695.27	695.27	732.9
No. of companies listed	982	1,021	1,021	1,025

Source: Bursa Malaysia

Performance of Selected Global and Regional Markets in the First Quarter of 2006 (30 Dec 2005 - 31 March 2006)

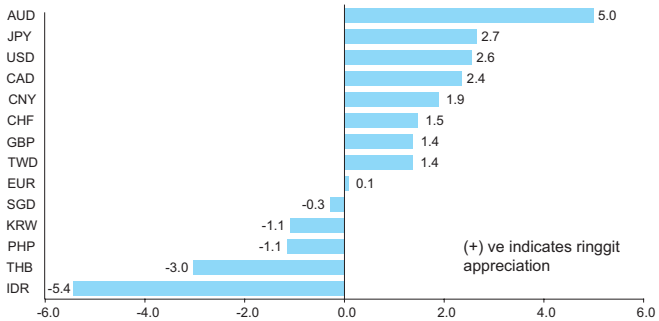


Exchange Rate Developments

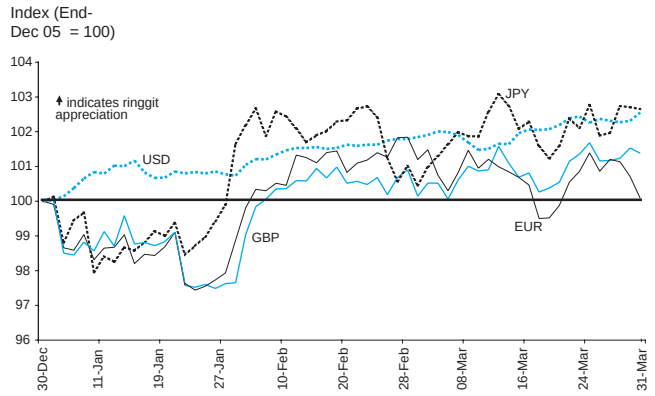
In the first quarter of 2006, the ringgit appreciated against the major currencies. The ringgit strengthened against the US dollar amidst a strong current account performance, renewed capital flows and brighter economic prospects. The US dollar weakened against most currencies including the ringgit due to market perception that the scope for further increases in the Fed Funds rate had become increasingly limited. The Japanese yen weakened against the US dollar as well as the ringgit amidst uncertainty surrounding the ending of Bank of Japan's quantitative easing framework, and as the benchmark interest rate was kept unchanged at near zero percent.

In the same period, the ringgit depreciated against most regional currencies in the range of 0.3% - 5.4%, while appreciating by 1.9% against the Chinese renminbi. The Indonesian rupiah appreciated amidst continued foreign inflows into equity and high-yielding assets. The Thai baht appreciated on market speculation for continued benchmark interest rate increases and foreign inflows into domestic equities. The Korean won and Philippine peso appreciated amidst continued

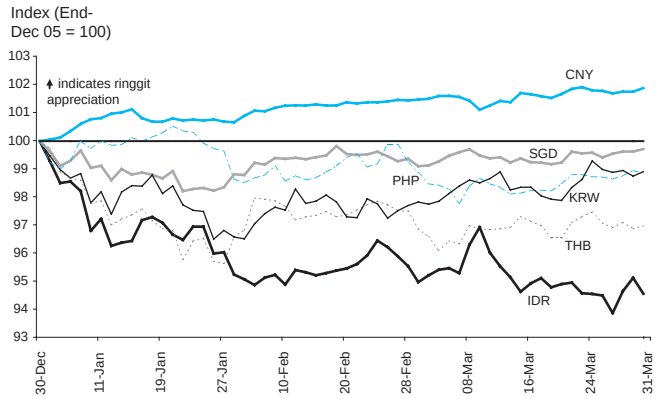
Summary of Ringgit Performance Against Selected Currencies
Percent Change (1 January - 31 March 2006)



Ringgit Performance Against Major Currencies



Ringgit Performance Against Regional Currencies



repatriation of foreign currency earnings. The Philippine peso also appreciated on market confidence for improved government finances.

Over the period 1 April – 29 May 2006, the ringgit strengthened further against the US dollar. Against regional currencies, the ringgit appreciated in the range of 1.5% - 4.8% against the Philippine peso, Indonesian rupiah and Chinese renminbi, while depreciating in the range of 0.2% - 1.4% against the Korean won, Singapore dollar and Thai baht.

Performance of Ringgit Against Selected Currencies

RM per foreign currency	As at end					% change since*			
	30 Jun 97	02 Sep 98	1Q 05	4Q 05	1Q 06	30 Jun 97	02 Sep 98	1Q 05	4Q 05
US dollar	2.5235	3.8000	3.8000	3.7800	3.6860	-31.5	3.1	3.1	2.6
Euro	-	-	4.9125	4.4867	4.4829	-	-	9.6	0.1
Pound sterling	4.1989	6.3708	7.1415	6.5226	6.4337	-34.7	-1.0	11.0	1.4
100 Japanese yen	2.2088	2.7742	3.5446	3.2229	3.1397	-29.6	-11.6	12.9	2.7
Singapore dollar	1.7647	2.1998	2.3034	2.2714	2.2778	-22.5	-3.4	1.1	-0.3
100 Thai baht	9.7470	9.3713	9.7013	9.2049	9.4914	2.7	-1.3	2.2	-3.0
100 Philippine peso	9.5878	8.8302	6.9381	7.1254	7.2077	33.0	22.5	-3.7	-1.1
100 Indonesian rupiah	0.1038	0.0354	0.0401	0.0385	0.0407	155.3	-12.9	-1.4	-5.4
100 Korean won	0.2842	0.2827	0.3734	0.3739	0.3781	-24.8	-25.2	-1.2	-1.1
Chinese renminbi	0.3045	0.4594	0.4509	0.4686	0.4599	-33.8	-0.1	-2.0	1.9

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

DEVELOPMENTS IN THE BANKING SECTOR

The banking system remained financially sound and resilient during the first quarter of 2006 against the backdrop of strong capitalisation and profitability as well as improvement in asset quality. This has further strengthened the banking system's position to extend financing to support economic growth.

Capitalisation sustained at strong level

The level of capitalisation remained strong despite recording a decline. The lower capital ratios were due largely to payment of dividends and expansion in lending activities. As at end-March 2006, the risk-weighted capital ratio (RWCR) and core capital ratio (CCR) were sustained above 13% and at 10% respectively.

Banking system: Capital Position

	2005				2006
	1Q	2Q	3Q	4Q	1Q
Capital					
CCR (%)	10.9	10.8	10.7	10.7	10.0
RWCR (%)	13.8	13.6	13.5	13.6	13.1

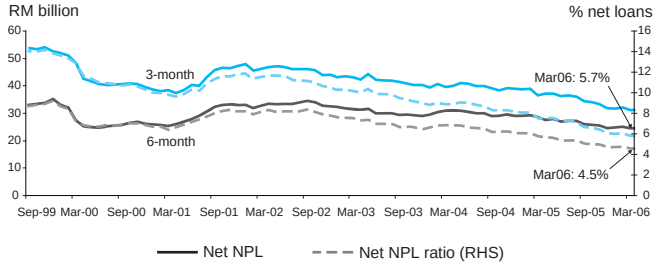
Profitability remained strong

The banking system registered pre-tax profit (PBT) totalling RM3.2 billion during the first quarter of 2006, a decline of RM0.3 billion attributable largely to higher investment income from dividend receipts in the final quarter of 2005. The profit level was, nonetheless, higher by 12.3% vis-à-vis the corresponding quarter of 2005. This was achieved on account of higher net interest and fee-based income totalling RM0.6 billion, as well as higher net gains from trading activities of RM0.1 billion. These increases more than offset the higher operating expenses (+RM0.4 billion or +9.3%) and lower recoveries (-RM0.1 billion or -9.6%). Consequently, the return on average assets remained unchanged at 1.3% whilst the return on average equity showed an improvement to 16.8% (1Q 2005: 1.3% and 14.9% respectively).

Continued downtrend in NPLs

Asset quality of the banking system continued to improve during the quarter with net non-performing loans (NPLs) based on the 6-month classification declining by 0.7% to RM24.4 billion. The improvement was due primarily to reclassifications of NPLs to performing status (+24.4%), recoveries (+17.4%) and write-offs (+15.3%). As a result, the net NPL ratio declined to its lowest level of 4.5% since the Asian financial crisis (4Q 2005: 4.6%). Similarly, net NPLs based on the 3-month classification recorded a decline of 0.7% to RM31 billion or 5.7% of total net loans (4Q 2005: 5.8%). The NPLs for the SME sector recorded an increase of RM0.4 billion to account for 10.4% of SME loans due primarily to the adoption of the broader SME definitions[1] (as endorsed by the National SME Development Council) by several banking institutions. Meanwhile, the household NPLs remained at 7.4% of household loans.

Banking system: Non-performing loans



[1] Definitions of SMEs differ in accordance with the economic sectors and have wider coverage following the redefinition of the qualifying criteria of **either** number of full-time employees **or** annual sales turnover.

Fifth Annual Islamic Finance Summit
24 January 2006, London

"Towards Evolving Islamic Finance as an Integral Component of the International Financial System"

Opening Speech by

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

It is my great pleasure to be here in London to speak at this fifth Annual Islamic Finance Summit organised by Euromoney. Islamic finance has made significant breakthroughs to now gain a place in today's challenging global environment with its international dimension now becoming increasingly more significant. It has now evolved to become an integral part of the international financial system. As this international financial integration process intensifies, it will not only increase the potential for Islamic finance to contribute towards enhancing the prospects for more balanced global growth through fostering greater trade and wealth creation, but also through facilitating greater diversification of risks, it will contribute towards increased global financial stability.

Rapid Evolution of the Global Islamic Financial Services Industry

As recent as five years ago, the development of Islamic finance was still regarded as an infant industry striving to prove its viability and competitiveness in the global financial environment. At that time, the growth of Islamic finance was mainly organic and largely concentrated in countries where the Muslim population was significant. Islamic finance was also for the most part governed by conventional regulatory and accounting standards. In addition, the divergence of views on some of the outstanding issues called for greater harmonization. Indeed, there was also some apprehension amongst the regulatory authorities, consumers, business communities and investors on the future potential of Islamic finance.

Notwithstanding this, over the recent five years, there has been a rapid evolution and expansion of the industry. Today, Islamic finance has been recognised as a viable and competitive form of financial intermediation not only in Muslim countries but also outside the Muslim world and offering a wide range of financial products and services. Licences are being issued to facilitate the establishment of Islamic banks including in the industrial economies in Western jurisdictions. There are also an increasing number of international conventional banking institutions offering Islamic financial products and services through dedicated subsidiaries or branches as well as through window arrangements. In addition, countries that have pockets of Muslim population, in particular, in the Asian region are now exploring the prospect of providing access to Islamic financial services to promote greater inclusion. These trends have not only been in terms of numbers of Islamic financial institutions, but also in terms of institutions with larger size of capital and a more established operational governance framework including risk management. Islamic financial institutions that previously operated only in their own domestic jurisdictions have also begun to venture abroad to tap new growth opportunities in other regions and forge greater cross-border linkages.

In the Islamic capital markets, there has been a growing interest in the issuance of Islamic *sukuks* by both sovereigns and multinational corporations. At the international level, the issuance of the first sovereign global Islamic *sukuk* by the Government of Malaysia in

2002 has been followed by a series of other issues. Corporations and multilateral development institutions have also embarked to issue Islamic financial instruments resulting in an increase in the range of products in the international capital market. Islamic *sukuks* have now breached the USD15 billion mark. The Islamic *sukuks* have attracted a broad range of investors. In 2004, to deepen our capital market further, Malaysia liberalized our exchange administration rules to allow multinational corporations and multilateral agencies to raise ringgit denominated papers in our domestic bond market. Multilateral financial institutions including the International Finance Corporation and the World Bank have since issued Islamic based ringgit-denominated instruments. We welcome the origination and issuance of Islamic financial instruments to be issued in Malaysia.

The growth in Islamic asset and wealth management has also been phenomenal arising from the diverse and innovative structures of Islamic investment funds, including Islamic hedge funds. It is estimated that more than 250 *Shariah*-compliant mutual funds are currently managing approximately USD300 billion in assets. *Shariah*-compliant screening techniques have been able to improve risk-adjusted returns on Islamic investment funds which in turn have led to its adoption in improving the risk-adjusted returns of conventional equity funds. Benchmark indices such as the Dow Jones Islamic Market Indexes and the Financial Times Stock Exchange Global Islamic Index Series in the international equity market and the listing of Islamic financial instruments on international exchanges have all contributed to enhance the depth of the Islamic financial markets as an attractive asset class for investment.

On the regulatory front, the standardised international rules and regulations for the Islamic financial institutions now being issued by the Islamic Financial Services Board (IFSB) will be important in effectively ensuring the stability and soundness of the system. Two important standards, the standards for capital adequacy and risk management have been approved by the Council of the IFSB in 2005. The two standards have taken into account the aspects of risks associated with the different contracts in Islamic banking business. Proper assignment of capital charge on profit-sharing arrangement and the introduction of profit equalization and investment risk reserve are risk-mitigating elements to ensure the soundness in Islamic banking business. The on-going work in the area of supervisory review process, market discipline, corporate governance and transparency will complete the range of the prudential and supervisory standards of Islamic financial institutions. The increased participation in the IFSB from across the globe reflects the growing interest of the global financial community to be involved, at the onset, in the development of regulatory standards in Islamic finance. In addition to these developments, regulatory and legal reforms are also being undertaken in a number of jurisdictions to accommodate the unique characteristics of Islamic financial transactions to support the progressive development of Islamic finance.

Following these institutional enhancements, the significant growth of Islamic financial markets and the development of the supporting financial infrastructure, the international financial architecture for Islamic finance has been strengthened considerably. Established international financial centres have now included the development of Islamic finance as part of their agenda. Also emerging on the horizon are new Islamic financial centres in which innovative and competitive Islamic financial services industry is evolving. With the supporting comprehensive Islamic financial infrastructure in place in Malaysia and the diversity of Islamic financial players following the recent increased liberalization in the Islamic finance sector, Malaysia is positioning itself as an international Islamic financial centre.

Key Challenges Ahead

While Islamic finance has made significant strides, there are key challenges that need to be addressed for Islamic finance to sustain its development in the global financial system. My remarks will focus on four of these challenges.

The development of robust Islamic financial system at the national level

Firstly, there is the challenge to develop a robust Islamic financial system at the national level. The level of development of Islamic finance across jurisdictions varies significantly. While in some, Islamic finance is at an advanced stage of development, in others, more meaningful progress is yet to be made. To foster greater international linkages and cross-border transactions, the level of development of Islamic finance needs to reach a certain threshold of development and sophistication. It requires the development of a robust Islamic financial system which encompasses both the banking and the non-bank Islamic financial intermediaries, the Islamic financial markets, offering the range of Islamic financial products that is supported by a developed Islamic financial infrastructure.

The formulation of the ten-year masterplan for the Islamic financial services industry by the Islamic Development Bank (IDB) and the Islamic Financial Services Board (IFSB), marks an important step in setting the blueprint for leading the development of Islamic finance in a systematic and synchronized manner across jurisdictions to achieve the common goal of a vibrant and comprehensive Islamic financial services industry. Malaysia had five years ago launched our own Financial Sector Masterplan which includes the strategic direction for the development of Islamic finance forward in Malaysia. It has now culminated in the progress that Malaysia has achieved today.

Malaysia has now evolved a comprehensive domestic Islamic financial system that is diversified in terms of its institutions, markets and players. The strategy has been to institute the entire financial system chain to ensure the smooth functioning of the system. The initiatives include building the required financial institutions including, the Islamic banking institutions, the *takaful* industry, the non-banking institutions and developing the Islamic money and capital markets. These respective components have recently been progressively liberalized to become internationally more integrated. The supporting financial infrastructure includes a robust regulatory and supervisory framework reinforced by the legal and *Shariah* framework, the payment and settlement systems, the development of the pool of talent and the mechanism for the liquidity operations of the Central Bank as part of its monetary policy conduct.

The development of efficient and active international Islamic financial markets

The second challenge is to advance further the development of an efficient and active international Islamic financial market. Well-developed international Islamic financial markets enhance the liquidity of the instruments and risk management capacity of the players. This would promote the efficient functioning of the markets and thus facilitate capital flows and thereby strengthen global integration. Co-ordinated initiatives are therefore essential to foster the development of an efficient and vibrant international Islamic financial market. Sustainable supply of *sukuks* on a regular basis needs to be ensured. The participation of issuers including multilateral organizations, governments and multinational corporations would contribute to this process. In Malaysia, the domestic bond market now accounts for 80% of GDP. Of this, 44% of the papers are Islamic based.

A fundamental pre-requisite is to promote innovation in the development of a broader range of Islamic financial market instruments. These include instruments with equity ownership features, Islamic asset-backed

securities, inclusion of permissible forms of credit enhancements as well as *Shariah*-compliant risk mitigating instruments. The development of an Islamic derivatives market for hedging is required for market-making activities to support the development of secondary markets. Research and development therefore need to be intensified. The *Shariah* fund recently established by Malaysia is to support research activities in these areas. This initiative is also to facilitate annual dialogues amongst international *Shariah* scholars. It is to provide a platform for deliberation on the *Shariah* compatibility of newly developed Islamic financial instruments and markets.

A further pre-requisite is to ensure sufficient availability of liquidity to support the intermediation of funds in the Islamic financial system. The demand for Central Bank discount window operations is inevitable. Central banks must therefore have sufficient Islamic financial instruments at its disposal to manage the liquidity conditions in the Islamic financial system. This is an area that has yet to be fully developed. In relation to this, Malaysia has developed Islamic monetary instruments that includes both the government and our own Bank Negara Malaysia Islamic financial instruments. We have also a dedicated clearing and settlement mechanism to ensure the smooth functioning of the Islamic financial system. To add to the existing range of Islamic financial instruments, Bank Negara Malaysia will in February this year issue an *Ijarah* paper to further meet the requirements of Islamic market players in the domestic Islamic money market and also for the purpose of conducting monetary policy. Of equal importance is having in place appropriate regulatory and legal framework to support the development of Islamic financial instruments and markets to ensure investor protection, uphold market integrity in addition to containing systemic risks.

The adoption of IFSB standards

The third is to ensure the adoption of the IFSB standards. The standards on capital adequacy and risk management that have now been approved by the Council of the Islamic Financial Services Board in December 2005 is scheduled for implementation in 2007. Islamic financial institutions must therefore be equipped with the required capacity and infrastructure to capture the respective risk weights and assign appropriate amount of regulatory capital at each of the different stages of the Islamic financial transaction. The exclusion of risk-weighted assets funded by the profit-sharing investment accounts from the calculation of regulatory capital requirement places critical emphasis on a comprehensive infrastructure in the Islamic financial institutions to clearly segregate the restricted and unrestricted profit-sharing investment accounts from the non-profit-sharing accounts and shareholders funds and to track their respective flows in financing and investment transactions. Strategic investments in the state-of-the-art IT and risk management systems are integral to this process.

Supervisory authorities need to be equipped with the specialized skills necessary to have the right assessments on the level of risks that the Islamic financial institutions are exposed to and the effectiveness of the risk management infrastructure in the Islamic financial institutions in mitigating these risks.

The development of a sufficient pool of talent in Islamic finance

Finally, the development of a sufficient pool of appropriately skilled Islamic finance practitioners needs to be accorded the highest priority. The required skill set in Islamic finance is unique. It needs to have the right blend of knowledge of finance with the understanding of the *Shariah* as being central. The *Shariah* principles must be embedded in each and every operational aspect of the Islamic financial institution, including in the design of financial products and financing structures, financial contracts and their execution, liquidity and balance sheet management, risk management as well as asset and wealth management. The upholding of *Shariah*

principles must permeate from the highest level, including at the board and senior management levels, which provide the strategic direction for the Islamic financial institution and to the operational levels. Sound policies and practices premised on *Shariah* principles will evolve the Islamic financial system into a financial system that is distinctively ethical and that which promotes economic justice.

To meet this objective of providing a total talent management solution for the global Islamic financial services industry and to meet the educational needs of the different levels of Islamic finance practitioners, including professionals and specialists in Islamic finance, Malaysia is establishing an International Centre for Education in Islamic Finance (INCEIF). INCEIF will commence operations in March this year and will offer professional certification programmes in Islamic finance. INCEIF will also forge strategic alliances with domestic and foreign academic institutions to offer post-graduate programmes, namely Masters and Doctorates in Islamic Finance with specific areas of specialization. A professional association for Islamic finance professionals will also be established for the alumni of INCEIF to keep abreast with the latest developments in Islamic finance.

Conclusion

Building the foundations on which Islamic finance has been able to advance forward has been vital to its viability, competitiveness and sustainability in this challenging global financial environment. With its integration into the international financial system, it would strengthen further the global economic and financial inter-linkages and in so doing would open new frontiers towards achieving more balanced global growth and greater shared global prosperity.

Second International Conference on Islamic Banking: Risk Management, Regulation And Supervision 7 February 2006, Kuala Lumpur

"Building a Robust Islamic Financial System"

Keynote Address by

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

Let me first of all extend a warm welcome to the participants of this Second International Conference on Islamic Banking: Risk Management, Regulation and Supervision, jointly organized by the Islamic Research and Training Institute (IRTI) of the Islamic Development Bank (IDB) and the Islamic Financial Services Board (IFSB). This forum has an important role of not only fostering the dissemination of knowledge and exchange of experiences on the subject of risk management, regulation and supervision, but also in facilitating a better understanding on the issues confronting us, and thus contribute towards advancing forward the development of the industry. Effective risk management capabilities is particularly important in this more challenging global financial environment of heightened uncertainties and increased potential for financial vulnerabilities. And an effective regulation and supervision will ensure the soundness and stability of the system. In the recent decade, the Islamic financial system has experienced remarkable growth and transformation, demonstrating its potential as a competitive form of financial intermediation. Today, Islamic finance represents a multi-billion dollar industry with a comprehensive range of products and services, serving a broad spectrum of consumers and businesses that extends beyond the Muslim world.

In developing the Islamic financial system, it is important to focus on the appropriate pre-requisites that will facilitate its efficient evolution. Fundamental to this is the development of the institutions, the markets, the range of financial products and services and having in place the legal, regulatory, supervisory, accounting and *Shariah* frameworks, as well as, for the monetary authority to have the capacity to manage its financial policies within this context.

With the development of these respective components having made significant progress, we are now seeing the Islamic financial services industry enter a new phase of development. Following increased liberalisation, the progress in the development of the international financial architecture for Islamic finance and the increased innovation resulting in the development of new products and services, the international dimension of Islamic finance is becoming increasingly more significant.

Islamic financial institutions are now also venturing their operations beyond their domestic borders. Islamic-based papers are also being issued in international financial markets, generating significant interest from global investors. The international financial architecture for the development of Islamic finance has also been strengthened with the establishment of the international standard setting bodies to draw-up the accounting and prudential standards. These developments have cumulatively evolved the Islamic financial system to increasingly become an integral component of the international financial system.

The Malaysian experience has been to develop a comprehensive domestic Islamic financial system that is diversified in terms of its institutions, markets and players. The strategy has been to institute the entire financial system chain to ensure the efficient functioning of the system. The initiatives include establishing the required financial institutions, including the Islamic banking institutions, *takaful* companies, the non-banking institutions and developing the Islamic money and capital markets. These respective components have recently been progressively liberalized in terms of allowing for the entry of new foreign players and in terms of increasing the potential for foreign participation in the domestic financial markets. In addition, both these domestic and foreign operations have been encouraged to tap on regional and international business opportunities. This move has strengthened the cross-border financial inter-linkages, prompting greater international integration. To ensure the robust functioning of the system, these developments are supported by a strong regulatory and supervisory framework reinforced by the legal and *Shariah* framework and the payment and settlement systems.

While the positive growth and developments in the Islamic financial system have brought about expanded opportunities, the financial liberalization and technological advancement have brought about increased competition and greater innovation in the development of products and services, operational processes and delivery channels. These developments have contributed to increasing the risk profile of the institutions. These new risks are generally more complex and have more profound systemic implications to the financial system. This has increased the need for strengthened risk management capabilities by the industry and for greater attention to this aspect by regulators and supervisors in ensuring the stability and integrity of the financial system. Of importance is to ensure an understanding and awareness of the risks inherent in Islamic banking activities. The challenge is to ensure that each component that supports the risk mitigation requirements, comprising the framework and institutional infrastructures, legal, regulatory, supervisory as well as the *Shariah* infrastructures are in place.

My remarks this morning will focus on the challenges of risk management in Islamic financial institutions, and the roles of effective regulation and supervision in this context as part of the efforts to promote the development of a robust and sound Islamic financial system.

In Islamic banking, the management of risks becomes more challenging due to its peculiar risk characteristics and the requirement for compliance to *Shariah* principles. While the Basel II initiatives on the identification of credit, market and operational risks can be assimilated into Islamic banking, the initiatives have to be complemented with consideration of the other dimensions of risks that are inherent in the Islamic financial transactions. The risk management infrastructure in Islamic financial institutions needs to identify, unbundle, measure, control and monitor all the specific risks in the Islamic financial transactions and instruments. This is to ensure that the systems and controls will be effective in the quantification and management of the risks arising from the operations.

New innovations in technology would be particularly important to enhance the potential to manage risks. In addition, as the returns in Islamic banking are uncertain and can only be ascertained on an ex-post basis, well-developed IT systems would be necessary to enable Islamic banking institutions to make projections on future returns so as to reduce the degree of uncertainty in the returns to be paid to the depositors. This would also strengthen the potential competitiveness of the Islamic financial services industry.

Another facet to risk management is the need for the Islamic banking industry to develop a

derivatives market. In the current increasingly uncertain global financial environment, investors need to be in a position to mitigate and manage these emerging new risks. Islamic banking institutions, in particular, have to a large extent long-term assets which include long-term Islamic housing mortgages and Islamic financial instruments, that are funded by short-term deposits, thus giving rise to a maturity mismatch between the assets and liabilities. There is therefore a need for the development of a broader range of Islamic financial market instruments to provide the industry with effective risk mitigating instruments.

In addition to the derivatives market, the Islamic financial system also needs deeper and more efficient money and capital markets to facilitate sound asset and liability, and liquidity management by Islamic financial institutions. In addition to the existing Islamic instruments, Bank Negara Malaysia will issue *sukuk Ijarah,* to meet the requirements of participants in the Islamic money market.

At the core of a strong Islamic financial system in any jurisdiction, there needs to be a strong regulatory framework that enforces the standards for capital adequacy, ensures effective risk management practices, financial disclosure and governance, reinforced by a strong *Shariah* and legal framework. *Shariah* principles serve as a self-regulating mechanism that protects Islamic financial institutions from unproductive, speculative and unethical activities, given the prohibition of interest in banking business, and the requirement that all financial transactions are to be accompanied by genuine trade and business-related transactions and the prohibition from the involvement in illegal and unethical activities. Thus, the regulatory framework in which Islamic banking operates is able to draw on the strength of the *Shariah* injunctions, to reinforce financial soundness and stability of the Islamic banking system.

In Malaysia, Islamic banking institutions are required to establish a *Shariah* committee within their respective institutions to ensure that the products and services to be introduced are *Shariah*-compliant. In addition, emphasis is also placed on the internal audit function to ensure that all transactions undertaken by the Islamic banking institutions are in compliance with the *Shariah* principles.

In designing and implementing financial regulation and supervision for Islamic banking institutions, the challenge is to enforce a framework that takes into account the unique characteristics of Islamic banking business, without being a regulatory burden and restricting its growth potential or providing arbitrage opportunities between the conventional and Islamic financial systems. In building a sound prudential framework for Islamic banking, aligning the regulatory capital requirements to the underlying risks, requires dichotomization of the risk intricacies in the Islamic banking asset portfolio, given the asset structure of Islamic banking institutions, such as the diverse spectrum of Islamic financing structures, which range from low-risk sales and lease-based modes to the higher risk equity-based modes of finance. The intricacy in profiling the risk in Islamic banking is further increased as the risks may transform from one type of risk to another at the various stages of the contract. For example, in the diminishing *Musharakah* contract, the Islamic financial institution initially acts as a joint-owner of the asset, but the asset ownership will be transferred fully to the customer at the conclusion of the contract. In this regard, the Islamic financial institution is exposed to higher market and impairment risks at the initial part of the transactions as compared to the exposure during the later stage of the contract. At the same time, the amount of repayment by customers represents the credit risk to the Islamic financial institution. As each of these respective parts of the transaction has a distinct intrinsic characteristic, it would entail different degrees of credit, market and operational risks. In this regard, in formulating prudential standards for Islamic banking institutions, there is a need to have an accurate assessment of the various risk variants underlying the alternative parts of the transaction to determine the capital

adequacy requirement. This is important to ensure the stability of the overall financial system.

Similarly, the liability structure of the Islamic banks is characterized by two distinct categories of deposits: the non-*Mudarabah* deposits which are not subject to the risk associated with the banking business and for which the principal is guaranteed, and the *Mudarabah* or investment deposits which involve risks and sharing of profits earned from the banking business. Given that the returns are not pre-determined, profit-sharing depositors of Islamic banking institutions, as the capital provider will also be exposed to the losses. This places a higher degree of fiduciary risk on the Islamic financial institutions in ensuring that the investment deposits funds are managed in the most effective and efficient manner. This is further compounded by competition in managing the liquidity in the system. The share of profits distributed needs to be competitive relative to that earned and paid by the conventional banks. This is important to avoid a shift of deposits and to retain the funds in the system.

A central feature of the regulatory framework for Islamic financial institutions is financial transparency and disclosure. Market conduct disclosure and customer relationship management form the core of these principles. Addressing the information asymmetry between Islamic banking institutions and the depositors is of vital importance. Under the *Mudarabah* principles, there is a need for disclosure by Islamic financial institutions to investors on how the funds are being managed so as to provide the assurance that the underlying business operations, the risk profile and the risk control mechanisms are in place. In Malaysia, this has been addressed through the rate of return framework, which provides a standard methodology for deriving the rate of return on deposits. The profit equalisation reserve, as provided in the rate of return framework for Islamic financial institutions, serves as a mechanism to mitigate the impact of the fluctuations in the rates of return. The reserve is appropriated from the gross income and is shared by both the depositors and the banking institution. Given the dual banking environment, as the one in Malaysia, the ability to maximize risk-adjusted returns on investment and sustain stable and competitive returns is an important element in ensuring the competitiveness of the Islamic banking system. From the regulatory perspective, the rate of return framework provides a means of assessing the efficiency of Islamic banking institutions, its profitability, management competency and fairness. To further protect Islamic depositors, the Malaysia Deposit Insurance Corporation has established a separate deposit insurance scheme based on Islamic principles.

Disclosure of the true and fair value of the Islamic banking operations in the financial statements is also essential for depositors to undertake a true and fair assessment of the bank's performance. The enhanced financial disclosures need to be complemented with customer education and awareness programs to elevate the level of financial literacy among the consumers and businesses. Towards achieving this objective, consumer education programs have been conducted, providing information among others, on the unique characteristics of Islamic banking and finance, Islamic financial products and services and the underlying *Shariah* principles and concepts. Enhanced consumer awareness is expected to strengthen the role of market discipline in driving the Islamic financial institutions towards strict *Shariah* compliance, enhanced operational efficiency, and strengthened risk management infrastructures and practices.

In Malaysia, Islamic banks and conventional banks with Islamic banking windows observe similar prudential standards as imposed on conventional banks such as the minimum risk weighted capital ratio (RWCR), standards for corporate governance and risk management, financial disclosures and know your customer policy. The principles of prudent management and enhanced operational efficiency are inculcated through the minimum risk weighted capital adequacy requirement.

Corporate governance standards have been enforced through specific guidelines on the code of conduct for directors, officers and employees of the banking institutions and guidelines on the directorship and prohibition of loans to directors, staff and their selected corporations. In addition, strict compliance with the tenets of *Shariah* would also ensure that the Islamic financial institutions are managed on the basis of a high degree of prudence, ethics and integrity.

The Basel Committee on Banking Supervision has enhanced its capital regulation to include operational risk in the computation of capital adequacy, in addition to credit and market risks. The task of formulating a framework that addresses the peculiar risks associated with Islamic banking is being undertaken by the Islamic Financial Services Board (IFSB), which serves as an international standard-setting body for regulatory and supervisory agencies. Its mandate is to develop prudential, regulatory and disclosure standards for Islamic finance, and promote uniformity in the best practices on the governance of Islamic financial institutions worldwide. In this respect, the IFSB has recently issued two prudential standards on risk management and capital adequacy for institutions offering Islamic financial services, which are recommended for implementation in 2007. The IFSB has also made progress in developing three other standards on corporate governance, transparency and market discipline, and the supervisory review process to be released in due course.

A key challenge in managing operational risk in Islamic banking is ensuring *Shariah* compliance. Bank supervisors in their assessment would need to give due attention to the adequacy of the financial institutions' board and management oversight, policies, procedures and limits, risk measurement, monitoring and management information systems, and internal controls. The risk management standards issued by the IFSB would serve as a guide to bank supervisors in this regard.

Notwithstanding the significant progress made so far, there are still outstanding issues confronting the Islamic financial system today, particularly the different interpretations of the *Shariah* injunctions. Internationally, there continue to be debates among *Shariah* scholars on the compliance to the *Shariah* principles. In Malaysia, we have invited prominent international *Shariah* scholars to participate in an intellectual discourse on *Shariah* matters with respect to Islamic banking and finance. The move is expected to foster greater harmonization and interaction among the *Shariah* Scholars from different parts of the world. In addition, a RM200 million endowment fund has been established by Malaysia to facilitate *Shariah* research activities and the development of competent *Shariah* scholars through scholarships and training.

The development of a vibrant Islamic banking sector cannot be achieved without the support of appropriate human capital development. Underpinning the success of Islamic banking system is the strengthening of research and intellectual capacity in the sphere of finance and *Shariah*. The Islamic banking industry needs to be equipped with a new breed of innovators, risk managers, regulators and supervisors who have the right blend of knowledge of finance and the understanding of the *Shariah*. For this purpose, Malaysia has established the International Centre for Education in Islamic Finance (INCEIF), which will commence operations in March 2006, aimed at developing talents in Islamic finance. INCEIF will offer professional certification programs in Islamic finance and will forge strategic alliances with domestic and foreign institutions of higher education to offer Masters and PhD. programs in Islamic finance in specific areas of specialisation.

As we advance forward, changes in the financial landscape will continue to accelerate and the level of complexity and sophistication in the financial markets will further intensify. Islamic banking institutions will need to reinvent themselves to meet the

emerging issues, challenges and opportunities. The regulatory and supervisory approach and the methodologies to be applied must continue to evolve in order to remain effective and relevant. In addition, given the global dimension of the Islamic financial products and services, and the increasing interdependence of financial markets, efforts by individual countries to strengthen risk management practices needs to be matched by efforts to enhance the safeguards at the international level.

The future prospect of the Islamic banking industry thus depends on the combined cumulative efforts by the industry, regulators, the market participants and the international community. The collective efforts needs to be co-ordinated to maximise the potential of the industry. Setting shared vision and common goals to be achieved would be an important first step. Of greater importance are the actions that needs to be taken to realise these goals. It will be the actions and initiatives which we take today that will contribute towards achieving the future that we aspire.

ICLIF Alumni Association Dinner
17 February 2006, Kuala Lumpur

Dinner Address by

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

It is my pleasure to be here this evening at this Inaugural Annual Dinner of the ICLIF Alumni Association. This occasion provides an excellent opportunity to promote greater engagement and networking among the industry leadership. This is particularly important for our region where the financial sector has experienced a pronounced transformation in the financial landscape. There will be new dimensions and new requirements for leaders and leadership capability in this new and highly challenging environment. It calls for being able to meet the new demands of the new economy, being able to perform in a more competitive environment, being able to reap the benefits of the new technologies and finally being able to operate in an environment of heightened uncertainty.

Despite these increased challenges, the world economy has entered 2006 on a stronger note. The latest indicators suggest that the global economic outlook remains favourable, with sustained growth across the major economies. While the US and China are expected to continue to experience strong growth, it is expected that the recoveries in Japan and Europe would provide additional support to global demand. This provides a positive external environment for Asia. In the Asian region, domestic demand has proved resilient with most countries experiencing a strengthening of domestic demand. Cumulatively, this rapidly expanding domestic demand has represented an important market for the region. It has also increased the pace of regional integration.

While energy prices have remained high, this is not expected to undermine the global growth momentum. Oil price increases thus far have mainly been demand-driven, and therefore, well absorbed compared to historical episodes of oil shocks. However, the tight global supply conditions that prevail have not removed the risks of higher oil prices. The inflationary trends that have emerged, has prompted the monetary authorities in a number of countries to raise interest rates. While the degree has varied across countries, these moves have primarily reflected the need to anchor expectations and limit the second-round effects of rising oil prices. This has therefore continued to allow monetary conditions to remain supportive of growth.

In view of the broadly favourable outlook for the global and regional economies, renewed attention has been focused on the prevailing imbalances in the global economy. This is a pertinent issue especially as these imbalances are expected to widen in 2006. It is recognised that reducing the global imbalances is a shared responsibility, across the major regions of the world. Several reasons have been cited as constraints to the process of adjustment. This include the relative lack of strength in domestic demand outside the US; the large gap between saving and investment in major regions of the world; and the fragmented structure of global capital intermediation that hinders surplus regions from financing productive investments within their region.

It is important to recognise the important role that Asia can have in contributing to rebalancing global growth and in so doing contribute towards global adjustment of the imbalances. In terms of economic growth, the region has consistently recorded performance that is, one-and-a-half times higher than the global average. On demographics, Asia is home to more than

half of the world's population, with a young and growing workforce, and expanding middle-class in a number of countries. Robust domestic consumption and rising investment have therefore become important sources of growth. This has been supported by the rising income and increased productivity and the expansion of intra-regional trade. The increasing importance of intra-regional trade, which accounts for more than 50% of Asia's total trade, makes the region the next most integrated region after the European Union in trade. This has positioned Asia as the largest and fast-growing market in the world. In addition, the Asian region has also embarked on measures to spur its economic openness by forging free trade agreements, which would contribute to increasing the capacity of the region and the potential of the region, in addition to improving prospects for contributing towards the rebalancing of global growth and the global adjustment process.

Combined with the region's traditionally high degree of economic openness with a total trade averaging 95% of GDP in the region, it reflects Asia's potential to be a self-sustaining and mutually reinforcing the region's growth. The greater degree of economic flexibility in the region in responding to shocks and the dynamic global conditions is a further feature that contributes towards strengthening the region's potential.

While private consumption's contribution to domestic demand is becoming increasingly more significant in the region a renewed expansion in investment is also needed to create a more sustainable growth path. Significant initiatives are already underway to increase the contribution of private investment and secure new areas of growth. These include improving the investment climate and reducing the cost of doing business. Efforts would also continue to be on-going on the priorities in the region as countries have the potential to further expand the role of domestic demand. For several of the countries in the region, a significant boost to investment is expected to stem from an expansion in physical and social infrastructure as well as from research and development activities being relocated to Asia.

On the financial front, the region's high savings rate and the pool of capital in the region for productive investments would be able to provide a boost to development of the region's financial markets. Strengthening the structure of the regional markets would facilitate the surplus savings to financing investment within the region. Significant progress has already been made in the Asian region in strengthening the financial sectors, in the banking system or the capital markets. This has increased the region's capacity to intermediate funds, especially within the region. The regional banking systems as a whole have increased their strength and ability to manage risks. This renewed resilience is being underpinned by more market-driven initiatives, improved standards of corporate governance as well as the development of the necessary infrastructure to promote the financial markets.

In this respect, regional financial ties underpin the reforms in the intermediation of capital and for re-channelling for productive investment within the region. The implementation of the Asian Bond Funds (ABF1 and ABF2) marks an important milestone in the path towards regional financial integration as part of the foreign reserves are invested in Asian sovereign bonds. Meanwhile, the introduction of ABF2 Funds as a new asset class in Asia, together with improvements to the financial infrastructure, tax and regulatory reforms, would contribute towards the broadening and deepening of regional bond markets over time. Building region-wide financial markets is relevant given that each regional market is typically small in size. Thus, inter-linked regional markets would raise the attractiveness of Asian investments to both global and regional investors.

Following these external developments, Malaysia's growth prospects are expected to

strengthen in 2006. The favourable external demand would reinforce the sustained expansion in domestic demand, which is expected to be positive for both real income and employment generation. Real private consumption is therefore set to grow further, while real private investment is forecast to expand, supported by the need to undertake capacity expansion, particularly in the manufacturing and oil and gas sectors, in addition to the services sector. As a result of both supportive external and domestic demand, the economy is expected to register improved performance in 2006.

For Malaysia, the focus of policy thrusts in 2006 would be to build on the gains of 2005, ensuring fundamentals are strengthened and the flexibility of the economy is further enhanced. In this respect, the Central Bank will determine the interest rate policy to provide a sound environment for sustainable performance of the economy. Macroeconomic policy would thus continue to stress growth in an environment of price stability. Of importance, is to strengthen private sector-led growth. Further efforts will therefore be undertaken to ensure that the economic and financial structures and systems are conducive for the building of a dynamic, resilient and flexible economy.

The dynamics of growth and development in the region are reshaping our environment. Effective chief executives and corporate leaders in this new environment need to develop accordingly taking into account the new requirements. In its programs, ICLIF has focused on these new dimensions of leadership development, particularly for the financial services sector.

As a leadership development institution, ICLIF has also evolved over time by continuously reviewing the contents of its programs to match the needs of the rapidly changing environment. A review of the Global Leadership Development Program (GLDP) has now been undertaken, based on the valuable suggestions and feedback from participants, faculty, facilitators and expert panel. Refinements in the structure and content of the GLDP are expected to be introduced in the subsequent sessions and will include, among other things, new areas such as geopolitical and economic trends, corporate entrepreneurship and innovation, diversity and inclusiveness, culture and corporate social responsibility. The US part of the Summer program will also be changed. The change will bring participants closer to distinguished faculty from such renowned institutions as Stanford, UC Berkeley and UCLA.

Let me now conclude my remarks. Leadership is all about a vision for the future, setting the strategic direction for the organization and having the ability to translate the vision into results. This involves having the ability to promote the shared vision and energizing the organization to produce the results.

Let me conclude with what I have mentioned to one of the groups of the GLDP program "The quest for leadership excellence is a journey and not a destination." When we talk about enhancing leadership capability, we are talking about leaders who are continuous learners, who strive for cutting edge excellence, leaders who have strong convictions and beliefs and yet having humility and recognizing the need to reinvent themselves and in doing so become dynamic leaders pushing the frontiers of excellence and having the courage to take on the new challenges.

Launching of The International Centre For Education In Islamic Finance (INCEIF), 23 March 2006, Kuala Lumpur

Luncheon Address by

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

It is my great pleasure and honour to welcome you to this luncheon in conjunction with the Meeting of the 1440 Hijrah Vision Commission of the Islamic Development Bank (IDB) and the Launch of the Vision Document that has taken place this morning for the transformation of the Islamic Development Bank to become the premier catalyst for greater shared prosperity and development among the ummah. We are most honoured today by the presence of Yang Amat Berhormat Dato Seri Abdullah Ahmad Badawi. I would like to take this opportunity to congratulate the IDB for the successful launch of the IDB 1440 Hijrah Vision. The Vision Document would serve as an important blue print for the transformation of the IDB into a dynamic Development Bank that will contribute to the "comprehensive human development", and thereby achieving prosperity for the ummah. We are also honoured today by the presence of His Excellency Tun Dr. Mahathir bin Mohamed, Chairman of the Commission, and His Excellency Dr. Ahmad Mohamed Ali, President of the Islamic Development Bank Group.

Today, we are also taking the opportunity of this very auspicious occasion, with the grace of Allah, to lay the foundations for another initiative, the launch of the International Centre for Education in Islamic Finance, INCEIF.

The Islamic banking and financial services industry has experienced profound growth in this recent decade. This growth is expected to accelerate further global expansion as demand for Shariah-compliant financial products and services intensify. To sustain and support the future growth of the industry, an important prerequisite is the development of the talent and expertise that is needed to drive innovation and to raise the performance of the industry to greater heights.

The establishment of the International Centre for Education in Islamic Finance (INCEIF) represents an investment in human capital to support the global development of the Islamic financial services industry. Human intellectual capital plays a pivotal role in driving the performance and market competitiveness of the industry. Going forward, it will be the defining factor. The fast pace of innovation in global financial services in general and in the Islamic financial services sector in particular, will demand new expertise and skills. Indeed, there will be an increase in demand for adequately qualified professionals. In this environment, the creation of a substantial pool of talent and expertise is thus indispensable for the future growth of Islamic finance. Strengthening research and development capabilities is also important for enhancing the capacity for innovation to meet the diverse requirements of the rapidly changing global economy.

The establishment of the International Centre for Education in Islamic Finance thus comes from the recognition of this need to invest in human capital to advance the industry forward to greater heights. Bank Negara Malaysia has allocated an endowment fund of RM500 million for this purpose. The income from the endowment fund will be utilised to finance the operations of INCEIF. The objective of INCEIF is to produce high-calibre practitioners and professionals in Islamic finance as well as specialists and researchers in the disciplines of Islamic finance. INCEIF will leverage on the wealth of

experience of the Islamic finance industry, both in Malaysia and abroad, to provide its graduates with value added insights and perspectives, in particular for their research programmes. Malaysia's experience in Islamic finance for over more than two decades will also provide a training environment, including for internships for developing Islamic finance professionals.

The required skill set in Islamic finance is unique. It needs to have the right blend of knowledge of finance with the understanding of the Shariah as being central. The Shariah principles must be embedded in every operational aspect of the Islamic financial institution, including in the design of financial products and financing structures, financial contracts and their execution, liquidity and balance sheet management, risk management as well as asset and wealth management. The upholding of the Shariah principles must permeate from the highest level, including at the board and senior management levels. Sound policies and practices premised on Shariah principles will evolve the Islamic financial system into a financial system that is distinctively ethical and that which promotes economic justice.

In meeting this objective of providing a total talent management solution for the Islamic financial services industry, INCEIF will offer the world's first certification on Islamic finance, the Certified Islamic Finance Professional (CIFP) programme. The CIFP modules to be offered has been designed by renowned experts of their respective fields and have been developed in full consultation with local and international industry players in order to ensure their relevance to the requirements of the industry. Following the launch of the INCEIF today, the programme will be open for registration. Classes for the first enrolment will commence in June 2006. INCEIF also offers post-graduate programmes in Islamic finance that will include specialised Masters and Ph.D. programmes in the various Islamic finance disciplines.

INCEIF will be governed by the INCEIF Governing Council and the Professional Development Panel. The INCEIF Governing Council, comprising eminent local and international professors from the academia and industry practitioners, will set the strategic direction and provide visionary global insights on the learning needs of the Islamic financial services industry. The Professional Development Panel, with vast experience in the Islamic finance industry and academia will represent the authority in academic matters and will have the responsibility for establishing the academic policies of INCEIF as will as the quality assurance of the CIFP and post-graduate programme modules. The academic faculty will include permanent as well as regular visiting professors and scholars-in-residence.

INCEIF will also form strategic alliances with leading local and international learning institutions to complement our pursuit to provide world-class knowledge for the benefit of the industry in particular, and the ummah in general. It is our vision that INCEIF will one day be an international nucleus for tertiary education in Islamic finance, training and research and provide a strong support in the development of Islamic financial infrastructure.

With the grace of Allah, and with the support of the international Islamic financial community, it is our hope that INCEIF will make a meaningful contribution to the future development of Islamic finance for the benefit of the ummah.

In closing, once again, I would like to express our deepest appreciation to the Yang Amat Berhormat, Dato' Seri Abdullah Haji Ahmad Badawi, Prime Minister of Malaysia for gracing this occasion and for accepting to officiate the launch of INCEIF.

CALENDAR OF EVENTS
January-March 2006

16 January 2006

In order to encourage greater participation of small and medium enterprises (SMEs) in the export markets, the Bank announced that all participating banks will offer two new trade finance products under both conventional and Islamic financing for the SMEs. The *Multi Currency Trade Finance* provides financing to Malaysian direct exporters in ringgit and major foreign currencies in the form of pre- and post-shipment financing. The *Indirect Exporter Financing Scheme* provides ringgit financing to indirect exporters without recourse, whereby the participating banks will discount their trade invoices arising from the supply of goods and services to direct exporters. Under this arrangement, the credit risks will be shared between the participating banks and Export-Import Bank of Malaysia Berhad.

17 January 2006

The Bank and the Securities Commission of Malaysia reported in a joint statement that the implementation of the framework on investment banks announced in 2005 was progressing as scheduled. It is envisaged that there would potentially be 17 investment banks emerging from implementation of the framework, and that discount houses and merchant banks would no longer be in the Malaysian financial landscape.

20 January 2006

The Monetary Policy Committee, decided to leave the Overnight Policy Rate (OPR) unchanged at 3%.

20 January 2006

The Bank announced that with immediate effect, the limit for investments in credit facilities by life insurers for the purpose of meeting the minimum required margin of solvency (MOS) has been increased from 50% to 70% of the MOS. This liberalisation will enable life insurers to achieve improved asset-liability matching, as well as accord them greater flexibility to invest in high-quality long-term bonds, thus contributing towards the development of the domestic capital market.

21 January 2006

Governor Tan Sri Dato' Sri Dr. Zeti Akhtar Aziz was conferred the honorary Doctor of Laws (LL.D.) by the University of Nottingham at the fifth graduation ceremony of the University's Malaysia campus. In her acceptance speech, the Governor spoke on the importance of investing in human capital to strengthen the intellectual capacity of the nation, as knowledge accumulation and application lies at the core of a country's competitive advantage in the current global economy.

24 January 2006

At the 5th Annual Islamic Finance Summit in London, the Governor spoke on four key challenges that needs to be addressed for Islamic finance to sustain its development in the global financial system, which are:

- the development of a robust Islamic financial system at the national level;
- the development of efficient and active international Islamic financial markets;
- the adoption of IFSB standards; and
- the development of a sufficient pool of talent in Islamic finance.

30 January 2006

The Bank granted four new takaful licences to the following consortiums and joint ventures:

- HSBC Insurance (Asia-Pacific) Holdings Limited, Jerneh Asia Berhad and Kumpulan Wang Simpanan Pekerja;
- Hong Leong Bank, Millea Asia Pte. Ltd, Japan, and Hong Leong Assurance;
- Bank Simpanan Nasional and Prudential Holdings Limited; and
- MAA Holdings Berhad and Solidarity Co., Bahrain

In line with the current shareholding policy, the new takaful operators are permitted to have foreign equity interest of up to 49%. With the new licensees the number of takaful operators in the country increased to nine.

7 February 2006

Governor delivered the keynote address at the Islamic Financial Services Board Second International Conference “Islamic Banking: Risk Management, Regulation and Supervision” in Kuala Lumpur. In her keynote address, she spoke on the challenges of risk management in Islamic financial institutions, as well as the importance of effective regulation and supervision, as part of the efforts to promote a robust and sound Islamic financial system.

9 February 2006

The Bank announced the introduction of a new Islamic monetary instrument, the Bank Negara Malaysia Sukuk Ijarah, to add to the diversity of monetary instruments used by the Bank in managing liquidity in the Islamic Money Market. A special purpose vehicle, BNM Sukuk Berhad, has been established to issue the instrument. Due to its regular issuance, the Sukuk Ijarah is expected to serve as a benchmark for other short to medium-term Islamic bonds. The inaugural issuance took place on 16 February 2006 with an issue size of RM400 million.

10 February 2006

The Bank announced the launch of the SMEinfo Portal, www.smeinfo.com.my, a one-stop online information gateway for SMEs. The SMEinfo Portal, an initiative of the National Small and Medium Enterprise Development Council, offers comprehensive information on all aspects of SME development. The portal also features a free SME Directory to promote business and networking opportunities among SMEs across all sectors of the economy.

14 February 2006

In commemorating "Songket – The Regal Heritage" as inspired by the promotional works started by the late Datin Paduka Seri Endon Mahmood, three types of commemorative coins – gold, silver and bi-metal – were issued. The launching ceremony for the coins was officiated by the Prime Minister, Y.A.B. Dato' Seri Abdullah Ahmad Badawi.

17 February 2006

At the Inaugural Annual Dinner of the ICLIF Alumni Association in Kuala Lumpur, Governor said that the new and highly challenging economic environment calls for leaders who are able to meet the new demands of the new economy, able to perform in a more competitive environment, able to reap the benefits of the new technologies, and finally able to operate in an environment of heightened uncertainty.

22 February 2006

The Bank announced that the Malaysian economy expanded an annual rate of 5.2% in the fourth quarter of 2005. The manufacturing and services sectors were the main drivers of this growth. A stronger upturn in exports provided added support to domestic private sector activities. Higher consumer sentiment and sustained business confidence underpinned the strong growth. For the whole of 2005, the combination of strong domestic demand and exports resulted in an overall growth in real gross domestic product of 5.3%.

The Monetary Policy Committee decided to raise the OPR by 25 basis points to 3.25% in order to align monetary conditions to the current environment. The stance of monetary policy continued to remain supportive of economic activity.

23 February 2006

Deputy Governor Datuk Zamani Abdul Ghani delivered a keynote address at the 2nd Seminar on Regulation of Takaful, themed "Building a Progressive Takaful Sector in the Overall Islamic Financial System" in Langkawi. The Deputy Governor shared the experience and approach that Malaysia has adopted to develop a comprehensive and effective Islamic financial system.

10 March 2006

The Minister of Finance announced that His Majesty the Yang Di-Pertuan Agong had consented to the extension of Tan Sri Dato' Sri Dr. Zeti Akhtar Aziz's tenure as Governor of the Bank for another five years from 1 May 2006.

22 March 2006

The 2005 Annual Report of the Bank was released. The Malaysian economy was expected to grow at a faster rate with real GDP expanding by 6% supported by strengthening exports and resilient domestic demand.

23 March 2006

The International Centre for Education in Islamic Finance (INCEIF) was launched by the Prime Minister of Malaysia. In her welcoming address, the Governor said that the establishment of INCEIF represents an investment in human capital to support the global development of the Islamic financial services industry. INCEIF will offer the world's first certification programme in Islamic finance, the Certified Islamic Finance Professional (CIFP), as well as post-graduate programmes that will include specialised Masters and Doctorate degrees in the various Islamic finance disciplines.