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

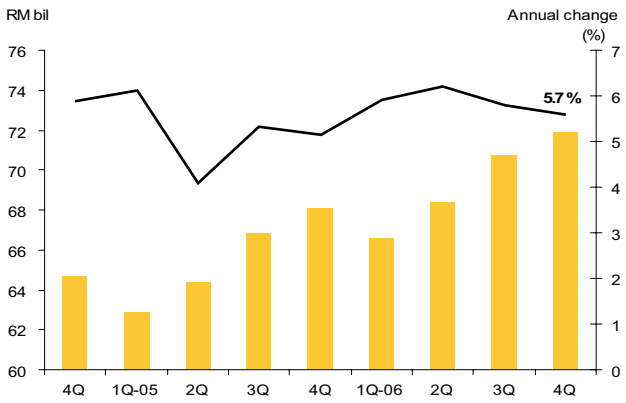
OVERVIEW

Sustained steady growth

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

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

Sustained Growth in 4Q 2006



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

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

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

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

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

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

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

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

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

Monetary policy remained supportive of economic activity

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

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

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

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

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

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

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

The banking system remained strong

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

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

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

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

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

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