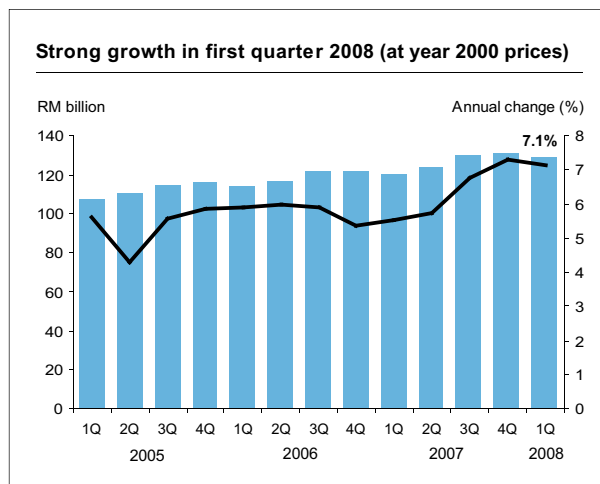


ECONOMIC AND FINANCIAL DEVELOPMENTS IN MALAYSIA IN THE FIRST QUARTER OF 2008

OVERVIEW

Strong GDP growth driven by strong consumption spending and external demand

The Malaysian economy registered a strong growth of 7.1% in the first quarter of 2008. The growth momentum was led by double digit expansion in private and public consumption spending, while investment activities remained resilient. Growth was further supported by a strong contribution from external demand, following stronger growth in exports, while imports moderated further during the quarter.



On the supply side, growth was broad based with strong growth recorded in all economic sectors. The manufacturing sector expanded by 6.9%, reflecting higher growth in both export- and domestic-oriented industries. The strong domestic demand and demand from the region for resource-based products, especially petroleum and chemical products, led to the stronger expansion in the manufacturing sector. In the electronics and electrical (E&E) sector, the computer and parts segment recorded a strong performance (17.4%), driven mainly by demand from the non-US markets, in particular Europe and the Asian region. Output of semiconductor products, however, expanded at a slower pace (0.3%) due to lower global demand.

The services sector continued to be the main driver of growth, expanding by 8%. Strong consumption activities contributed to higher increase in the wholesale and retail trade, accommodation and restaurant, finance and insurance as well as transport and storage sub-sectors.

The primary commodity sector recorded a stronger performance with the agriculture sector expanding by 6.3% and the mining sector by 3.7%. The strong growth in the agriculture sector was led by higher crude palm oil output, while the higher growth in the mining sector was sustained by increased production of crude oil following higher output from the Kikeh oil field. The construction sector continued its growth momentum, supported mainly by infrastructure projects related to the oil and gas sector and the Ninth Malaysia Plan.

Domestic demand expanded at a stronger growth pace of 10.1% in the first quarter of 2008 (4Q 2007: 9.1%). Private consumption expenditure registered a growth of 11.8% supported by rising disposable income, strong export performance and favourable labour market conditions. Similarly, public consumption grew by 10.5% due to higher expenditure on emoluments, defence, and supplies and services.

Gross fixed capital formation grew at a more moderate pace of 6%. Key investment indicators such as growth in sales of commercial vehicles, loans disbursed to businesses, and imports of capital goods showed strong capital expenditure, particularly in the construction and manufacturing sectors. This is further supported by steady inflows of foreign direct investment into the manufacturing and oil and gas industries. The Government's development expenditure was steady, and continued to focus on providing essential services such as agriculture and rural development, improvement

to public utilities and transport infrastructure, as well as provision of housing, education and health services.

The headline inflation rate, as measured by the change in the Consumer Price Index (CPI), increased to 2.6% in the first quarter of 2008 (4Q 2007: 2.2%), due mainly to higher prices in the food and non-alcoholic beverages category and to a lesser extent, in the restaurants and hotels; and miscellaneous goods and services categories. In April, the CPI increased further to 3.0%.

On the external front, the trade account recorded a surplus of RM26.8 billion in the first quarter of 2008 (4Q 2007: RM28.4 billion). Gross exports expanded by 9.8%, the fastest pace since the third quarter of 2006, due mainly to the strong growth in commodity exports. Agriculture exports performed exceptionally well, driven by high prices and increased global demand for crude palm oil and rubber. Similarly, exports of crude oil and liquefied natural gas also expanded strongly. Meanwhile, manufacturing exports expanded at a more moderate pace of 0.8%, as robust growth in exports of resource-based products cushioned the contraction in E&E exports.

Gross imports expanded at a moderate pace of 6.7% due mainly to slower growth of imports of intermediate goods (8.7%), particularly inputs for the E&E industry. Imports of capital goods (excluding lumpy items) increased by 12.8%, led by strong activities in the mining and construction sectors. Imports of machinery and office equipment remained strong in tandem with sustained investment activities in the manufacturing and services sectors. Higher seasonal demand during the festivities and positive consumer sentiment led to higher imports of consumption goods (6%), particularly food and beverages, transport equipment as well as durable and semi-durable consumer goods.

In the financial account, gross inflows of foreign direct investment (FDI) on a cash basis, amounted to RM6.8 billion in the first quarter (4Q 2007: RM12.9 billion). About

half of the FDI inflows were directed into the services sector, followed by the oil and gas and manufacturing sectors. After adjustments for gross outflows due mainly to repayments of the short-term loans, net FDI inflows amounted to RM1.7 billion (4Q 2007: RM3.4 billion). Overseas investment by Malaysian companies recorded a net outflow of RM4.9 billion (4Q 2007: -RM4.8 billion). Meanwhile, portfolio investment recorded a net inflow of RM1.5 billion (4Q 2007: RM4.7 billion). Higher inflows of foreign funds for investment in debt securities more than offset outflows arising from the net liquidation of equity securities by foreign investors.

Effective from the beginning of 2008, the external debt data of Malaysia has been redefined to treat entities in Labuan International Business and Financial Centre (IBFC) as residents. Under this new definition, debt exposure of these offshore entities vis-à-vis the rest of the world will be included in Malaysia's external debt while debt exposure of residents with offshore entities in Labuan IBFC are excluded. This is aimed at facilitating a strengthened risk assessment for the economy as well as to be consistent with the international standards and best practices on the treatment of offshore entities in external data compilation. Under this new definition, Malaysia's external debt amounted to RM211.2 billion (or USD63.1 billion) as at end-2007, equivalent to 33.6% of Gross National Income (GNI), compared with RM187.4 billion (or USD56 billion) or 29.9% of GNI under the old definition. The profile of the external debt continued to be skewed towards a longer maturity structure. As at end-March 2008, Malaysia's external debt position was at RM212.8 billion (or USD65.9 billion), equivalent to 31.1% of GNI. A moderate increase in the short-term debt, due mainly to inter-bank borrowings, particularly by offshore financial entities in Labuan IBFC, was offset by a lower medium- and long-term debt attributable to the exchange revaluation gain and net repayment by the Federal Government.

The international reserves of Bank Negara Malaysia amounted to RM384.7 billion (equivalent to USD120.3 billion) as at

31 March 2008. The reserves increased to RM399.9 billion (equivalent to USD125.1 billion) as at 15 May 2008. The reserves position is sufficient to finance 9.9 months of retained imports and is 5 times the short-term external debt.

Monetary policy remains supportive of economic activity

The Overnight Policy Rate (OPR) remained at 3.50% throughout the first quarter of 2008, as the prevailing level of the policy rate remained consistent with the outlook for economic growth and inflation.

Concurrently, interbank rates for all maturities were relatively stable during the quarter. In terms of lending rates, the average base lending rate (BLR) remained unchanged during the quarter, while the average lending rate (ALR) softened to 6.21% at end-March. Deposit rates remained relatively unchanged.

Despite the continuing uncertainties in the global financial markets, which led to some volatility in the domestic financial markets, domestic credit conditions remained favourable during the quarter. Demand for financing continued to be supported by ample liquidity in the domestic financial system. On a net basis, banking system loans and PDS outstanding expanded at a faster pace of 12.7% at end-March. Loans outstanding increased markedly by 10% at end-March due to both the business and household sectors, with loans outstanding to these sectors expanding at higher annual rates of 11.6% and 8% respectively. Loan applications, approvals and disbursements remained high across the business and household sectors, and continued to increase on an annual basis.

In the capital market, net funds raised during the quarter were significantly higher at RM12.4 billion. Net funds raised by the public sector were higher at RM10.6 billion, while net funds raised through the PDS market amounted to RM700 million. Funds raised through the equity market amounted to RM1.1 billion.

M3, or broad money, expanded significantly by RM51.6 billion or at an annual rate of 12.1% at the end of the first quarter. The increase mainly reflected net inflows stemming from trade, foreign direct investments and portfolio investments. The expansion in M3 was also supported by increased lending to the private sector and to a lesser extent, expansionary Government operations.

The ringgit experienced greater two way movements during the first quarter, reflecting volatile portfolio flows as investors reacted to events related to the turbulence in the international financial markets, and reassessed their positions on concerns that the US economic slowdown would have a spillover effect upon the region. Nevertheless, the upward trend of the ringgit as well as other regional currencies against the US dollar during this period was supported by the positive investor sentiment towards the Asian region, as well as the weakness of the US dollar arising from the deteriorating fundamentals of the US economy. Overall, while appreciating against the US dollar, the ringgit recorded a mixed performance against the other major currencies as well as against regional currencies. During the period 1 April to 27 May, the ringgit appreciated against the Japanese yen but depreciated against most other major currencies. The ringgit also appreciated against several regional currencies while depreciating against others.

Banking system continued to exhibit high resilience

The banking sector continued to exhibit high resilience in the first quarter of 2008. The capitalisation of the banking system remained strong with risk-weighted capital ratio (RWCR) and core capital ratio (CCR) of 13.2% and 10.2% respectively as at end-March 2008. The banking system also registered a growth of 7.1% in unaudited pre-tax profit to RM5.7 billion. Meanwhile, the NPL level of the banking system continued to improve, with the total net NPLs based on the 3-month classification declining further by 5.2% to RM19 billion as at end of the

first quarter, to account for 3% of total net loans. As at end-April 2008, the net NPL ratio declined further to 2.9% on account of sustained repayments and recoveries.

Growth to remain on a steady path into the second half of 2008

Uncertainties in the global economic environment remain, with the global growth outlook expected to continue to be mixed, with moderation in industrial economies while growth in the Asian region is expected to be sustained. Overall, global growth is expected to moderate further going forward. In this environment, the Malaysian economy is expected to continue to remain resilient, supported by sustained growth in

domestic demand reinforced by expanding intra-regional trade. Despite rising inflationary concern, consumption activities are expected to be supported by favourable labour market conditions and high commodity prices. Key investment indicators, including imports of capital goods, loans to businesses and manufacturing investment approvals, as well as inflows of foreign direct investment, suggest that private investment activity remains positive. In addition, domestic credit conditions continue to be supportive of consumption and investment activities. Near-term indicators as well as the latest six-month smoothed growth rate of the Department of Statistics, Malaysia (DOSM) leading index indicate the underlying strength of Malaysian economy into the second half of 2008.

DEVELOPMENTS IN THE FIRST QUARTER OF 2008

INTERNATIONAL ECONOMIC ENVIRONMENT

Sustained growth in most major regions despite weak growth in US

Global growth performance in the first quarter 2008 was mixed amidst weak growth in the US economy. Growth momentum was sustained in Asian economies and supported by firm growth in the euro area and Japan. In the **US**, the first quarter advance estimate showed that real GDP growth weakened significantly to 0.6% (4Q 2007: 0.6%), supported largely by a build up in inventories, which contributed 0.8 percentage points to growth. Consumption increased modestly by 1% (4Q 2007: 2.3%), with spending on services offsetting the decline in expenditure on goods. Net exports remained supportive. Meanwhile, housing investment fell for the ninth consecutive quarter while business investment declined on weaker spending on non-residential structures, and equipment and software. On inflation, prices increased by 4.2% in the quarter (4Q 2007: 4.0%), the highest since 1991, on higher energy and food prices.

In **Japan**, first quarter real GDP expanded by an annualised 3.3% (4Q 2007: 2.6%), driven by net exports which benefited from strong exports to Asia and emerging markets. On the inflation front, prices rose by 1% (4Q 2007: 0.5%), with core prices reaching positive

territory for the first time in nearly 10 years. This was attributed to price increases in energy- and food-related items.

A better-than-expected 2.2% growth was recorded in the **euro area** in the first quarter. Resilience in the region was mainly due to stronger growth in Germany and a rebound in France. Germany expanded by 2.6% (4Q 2007: 1.8%), due to investment and consumer spending; while growth in France was supported by a recovery in exports. Growth in these two large countries helped compensate for the slower growth in Spain (2.7%) and other smaller euro area countries. Meanwhile in the **UK**, economic growth in the first quarter slowed to its weakest rate in three years as the services sector lost momentum due mainly to moderation in business services and finance activity. Slower activity is also evident in industrial production and construction.

In the **US**, the **Federal Open Market Committee** (FOMC) lowered interest rates aggressively on concerns of weak growth amidst continued financial market turbulence. In the first quarter of 2008, the FOMC reduced interest rates by 200 basis points. From September 2007, when the federal funds rate easing began, to end-April 2008, interest rates have been reduced by a cumulative 325 basis points to 2%.

Industrial Countries: Real GDP Growth

	2007			2008	Key contributing factors for 1Q growth
	1Q	4Q	Year	1Q	
	Annual change (%)				
US ¹	0.6	0.6	2.2	0.6 ^a	Supported by a modest expansion in consumption and government spending, inventory accumulation and a positive contribution from net exports, while housing and business investment declined.
UK	3.1	2.9	3.1	2.5	Slower growth in services sector, especially business services and finance.
Euro area	3.2	2.2	2.7	2.2 ^a	Supported by strong growth in Germany and a rebound in France.
Japan ¹	4.6	2.6 ^r	2.1	3.3 ^p	Supported by exports and private consumption.

¹ Annualised basis
^a Advanced estimate
^r Revised
^p Preliminary

Source: National authorities

The Federal Reserve Board (Fed) also undertook several measures to address market liquidity strains since the end of 2007. These include an expansion of the Term Auction Facility (TAF), increasing the currency swap lines with the European Central Bank and Swiss National Bank, and creating new facilities (Term Securities Lending Facility and the Primary Dealer Credit Facility) for primary dealers to have access to funds and more liquid securities. The Fed also facilitated the purchase of a US investment bank, by extending USD29 billion of financing at the discount rate.

In other industrial economies, the **Bank of Japan** kept interest rates at 0.5% despite a gradual rise in consumer prices as weaker external demand conditions raised the risks to economic growth. The **European Central Bank** (ECB) continued to maintain policy rates due to concern over inflation despite increasing risk of economic slowdown in the wake of credit market turbulence. Inflation data for March rose to 3.6%, more than a percentage point above the ECB's 2% target. The **Bank of England**, however, cut interest rates by 25 basis points in the first quarter of 2008 and again at its April meeting amidst signs of a slowing economy and weakening financial sector.

Prices of several **commodities** have reached new record highs this year due to sustained firm demand, supply concerns, weaker US dollar and to some extent, speculation in the

commodity markets. In the first quarter of 2008, crude oil prices averaged USD98 per barrel (2007 average: USD72). More recently, rice, the world's second-biggest food grain crop, recorded a new high. Rice prices have hit successive peaks due to worries over supply shortages, and been associated with social concerns and export restrictions in several countries.

In the **Asian region**, first quarter growth remained supported by domestic demand and strong export performance. Despite slowing demand from the US, export activity was sustained by demand from other non-US markets, high commodity prices, and increased intra-regional trade. Regional growth continued to be led by China which posted 10.6% growth in first quarter. Notwithstanding the resilience in economic growth seen so far, inflation remains a concern across the Asian region due mainly to rising food and energy prices. Amidst these developments, most regional central banks maintained interest rates due to concerns over slowing economic activity, despite rising inflationary pressures.

In the **foreign exchange market**, the US dollar ended the quarter weaker against major currencies. Dollar performance was mainly influenced by prospects of a greater slowdown of the US economy and rate cuts by the Fed. The US dollar, however, recorded a first monthly gain this year in April against the euro and yen as the Fed was seen to be approaching a pause

Regional Countries: Real GDP Growth

	2007			2008	Key contributing factors for 1Q growth
	1Q	4Q	Year	1Q	
	Annual change (%)				
PR China	11.7	11.2	11.9	10.6	Economic activity was sustained by higher fixed asset investment, retail sales and industrial production.
Hong Kong SAR	5.5	6.9	6.4	7.1	Sustained by robust investment and resilient exports.
Singapore	7.0	5.4	7.7	6.7	Driven by biomedical manufacturing, construction and financial services.
Indonesia	6.0	6.3	6.3	6.3	Supported by strong exports and investment.
Korea	4.0	5.7	5.0	5.7 ^a	Supported mainly by the manufacturing sector. Resilient export performance offset the moderation in domestic demand.
Thailand	4.3	5.7	4.8	6.0	Supported by private consumption and investment.

^a Advanced estimate

Source: National authorities

in its policy cycle. Most regional currencies also strengthened in the quarter against the US dollar due to continued strong trade-related and portfolio inflows.

Going forward, global growth is expected to moderate due to slowing growth in the major industrial economies and continued uncertainties in the global financial markets.

The ongoing slowdown in the US economy remains a risk to global growth, while economic activity could also be affected by increasing inflationary pressures from rising food and energy prices. Growth in the Asian region, however, is expected to remain supported by firm domestic demand amidst a cautious outlook on export performance. Meanwhile, high fuel and food prices remain a concern in the Asian region.

DEVELOPMENTS IN THE MALAYSIAN ECONOMY

Strong GDP growth led by strong consumption spending and external demand

The Malaysian economy registered a strong growth of 7.1% in the first quarter of 2008. The growth was led by double-digit expansion in private and public consumption spending, while investment activities remained resilient. Growth was further supported by a strong contribution from external demand, following stronger growth in exports, while import growth moderated further during the quarter.

Growth was broad based, with all sectors recording strong performance. The manufacturing sector recorded higher growth led by expansion in domestic-oriented and resource-based industries. Similarly, the agriculture sector also registered a stronger performance driven by double-digit expansion in crude palm oil output amidst the recovery in yields, while the expansion in the mining sector was contributed

Quarterly GDP by Kind of Economic Activity at Year 2000 Prices¹

	2007			2008
	1Q	4Q	Year	1Q
	Annual change in (%)			
Agriculture	3.8	4.7	2.2	6.3
Mining	-0.4	3.5	3.3	3.7
Manufacturing	2.0	5.6	3.1	6.9
Construction	4.1	4.7	4.6	5.3
Services	9.4	9.3	9.7	8.0
Real GDP (Annual Change)	5.5	7.3	6.3	7.1
Real GDP (Preceding Change)	-1.6	0.8	6.3	-1.8

¹ The GDP has been rebased from 1987 prices to 2000 prices

Source: Department of Statistics, Malaysia

by increased production of crude oil. Meanwhile, strong domestic demand and finance-related activity underpinned the growth in the services sector. The construction sector continued its growth momentum, supported mainly by civil engineering activity related to the oil and gas sector, and implementation of the Ninth Malaysia Plan projects.

Manufacturing sector led by domestic-oriented and resource-based industries

The strong domestic demand and demand for resource-based products from the regional countries supported the higher expansion in the **manufacturing sector** of 6.9% during the quarter (4Q 2007: 5.6%).

Performance in the Manufacturing Sector

	2007			2008
	1Q	4Q	Year	1Q
	Annual change (%)			
Value Added (Constant Price)	2.0	5.6	3.1	6.9
Overall Production	0.7	4.9	1.9	6.4
Export-oriented industries	-0.2	3.4	0.7	4.5
<i>Of which:</i>				
Electronics and electrical	-5.5	5.5	-0.9	2.9
Electronics	-4.0	10.3	1.5	3.6
Electrical	-10.3	-9.5	-8.7	0.7
Chemicals and chemical products	7.3	-1.4	1.8	4.0
Petroleum products ¹	5.0	3.7	5.4	8.2
Rubber products	16.9	1.6	5.9	3.3
Off-estate processing	-1.3	12.0	-0.5	20.1
Domestic-oriented industries	4.9	10.9	6.8	14.0
<i>Of which:</i>				
Construction-related materials ²	3.3	5.1	5.0	14.5
Fabricated metal products	21.9	19.0	19.4	16.4
Transport equipment	-21.9	15.3	-6.0	20.8
Food	16.2	8.3	7.6	8.2
Total Manufactured Exports	1.4	3.0	0.3	0.8
<i>Of which:</i>				
Electronics and electrical products	-2.0	-2.1	-4.2	-9.4
Chemicals and chemical products	33.8	9.1	13.8	6.7
Petroleum products	-24.5	43.7	3.8	93.4
Rubber products	31.0	20.6	13.4	21.9
Furniture & parts	7.9	1.5	5.9	0.6

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

² Includes iron & steel and non-ferrous metal as well as non-metallic mineral products

Source: Department of Statistics, Malaysia

In the **export-oriented industries**, while growth in the electronics and electrical (E&E) sector was dampened by weaker external demand, resource-based industries continued to be supported by demand from the region, especially for petroleum and chemicals products. Activity in the off-estate industry was also stronger in line with higher output

of commodities during the quarter. In the E&E sector, output of computer and parts segment recorded a strong performance (17.4%), supported mainly by demand from the non-US markets, especially Europe and the Asian region. Output of semiconductor products, however, expanded at a slower pace (0.3%; 4Q 2007: 8.8%) due to lower global demand.

Performance of **domestic-oriented industries** strengthened further during the quarter, reflecting broad based expansion across all segments. Industries related to the construction sector registered double-digit expansion, benefiting from the robust domestic construction activity as well as regional demand. Meanwhile, strong sales in new motor vehicles supported growth in output of the non-metallic mineral products and transport-equipment industry.

During the quarter, the manufacturing sector was operating at a capacity utilisation rate of 78%, with the capacity utilisation rate for export- and domestic-oriented industries averaging at 79% and 74% respectively.

Capacity Utilisation Rate in the Manufacturing Sector *



* Beginning 2004, the capacity utilisation rate in the manufacturing sector has been rebased from value-add in year 2000 to value-add in year 2004

Services sector the main driver of growth

The services sector remained the main driver of growth during the quarter, contributing 4.3 percentage points of overall GDP growth. The expansion was led by wholesale and retail trade, accommodation and restaurant, finance and insurance, and transport and storage sub-sectors.

Performance in the Services Sector (value added at year 2000 prices)

	Share 2007	2007			2008
		1Q	4Q	Year	1Q
	%	Annual change in (%)			
Intermediate Services	43.7	12.8	10.2	11.7	8.3
Finance & insurance	19.9	13.8	10.0	11.1	9.9
Real estate & business services	9.8	22.5	11.1	18.2	4.5
Transport & storage	7.0	5.6	12.4	10.0	9.8
Communication	7.0	5.4	7.2	7.0	7.5
Final Services	56.3	6.8	8.6	8.1	7.8
Electricity, gas & water	5.6	4.1	3.0	3.9	4.6
Wholesale & retail trade	22.8	9.2	12.9	12.5	12.4
Accommodation & restaurant	4.4	7.8	12.3	10.8	10.0
Government services	12.9	6.3	5.0	4.5	2.8
Other services	10.6	3.7	5.4	5.0	5.2
Total Services	100.0	9.4	9.3	9.7	8.0

Source: Department of Statistics, Malaysia

Selected Quarterly Indicators in the Services Sector

	2007				2008
	1Q	2Q	3Q	4Q	1Q
	Percentage at end-period (%)				
Cellular phone penetration rate	77.0	78.2	80.8	85.1	87.9
Internet subscribers penetration rate	14.0	14.2	14.3	14.3	14.5
Broadband subscribers penetration rate	3.7	4.1	4.5	5.0	5.4
	Index				
MIER Consumer Sentiment Index	124.1	115.9	117.5	110.7	115.5
MIER Retail Trade Index	118.8	129.5	145.9	141.2	106.1
MIER Tourism Market Index	133.8	131.6	131.1	133.6	120.3
	Annual change (%)				
Total consumption credit outstanding	7.8	7.4	7.1	7.3	7.2
Loans outstanding to the wholesale & retail trade, hotels & restaurants	1.8	-0.2	6.1	7.2	10.5
Imports of consumption goods	8.9	1.1	1.2	3.8	6.0
Total sales of motor vehicles	-15.3	-9.1	4.9	19.0	24.7
Container cargo handled (Port Klang and PTP)	18.5	12.2	9.7	14.4	9.7

Source: Various sources

Growth in the **wholesale and retail trade**, and **accommodation and restaurant** sub-sectors were sustained at a high level supported by strong domestic consumption activities, as reflected in the high growth of consumption imports (10.1%), loans outstanding to the wholesale and retail sector (10.5%) and sales of new motor vehicles (24.7%) during the quarter.

Meanwhile, the **finance and insurance** services sub-sector was driven by higher intermediation activity as well as continued expansion in fee-based activity in the banking sector. Growth was further supported by the insurance segment. Meanwhile, the **transport and storage** sub-sector sustained a strong double-digit growth led by both the cargo and passenger segments, amidst strong trade activity and increased travel by Malaysians and foreign tourists.

Higher growth in commodities

The **agriculture sector** expanded strongly by 6.3% in the first quarter, driven by high production of crude palm oil following the recovery of the yield cycle, with yields rising by 15.8%. The growth was also supported by the favourable performance in the other agriculture segment, namely fruits and vegetables, as well as livestock. Meanwhile, the **mining sector** saw an increased output of crude oil (including condensates) of 5.5% to 709,640 barrels per day, on account of higher output from the Kikeh

Performance in the Agriculture Sector

	2007			2008
	1Q	4Q	Year	1Q
	Annual change (%)			
Value Added (at year 2000 prices)	3.8	4.7	2.2	6.3
Industrial Crops	3.8	6.1	0.0	9.1
Food Crops	3.8	2.8	5.3	2.5
Production				
<i>Of which:</i>				
Crude palm oil	-1.4	12.9	-0.4	23.9
Rubber	-6.9	-7.6	-6.6	-1.6
Fish	3.8	4.9	0.2	0.4
Livestock	18.1	6.5	9.9	1.0
Exports (RM million)	7.7	37.8	24.4	66.2
<i>Of which:</i>				
Palm oil	18.2	65.2	47.8	104.3
Rubber	-12.9	2.9	-10.9	30.8
Sawn timber	7.4	-21.4	-5.4	-21.6
Saw logs	-10.5	-18.7	-6.6	-1.8

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

Performance in the Mining Sector

	2007			2008
	1Q	4Q	Year	1Q
	Annual change (%)			
Value Added (at year 2000 prices)	-0.4	3.5	3.3	3.7
Production				
<i>Of which:</i>				
Crude oil and condensates	-1.9	7.2	4.3	5.5
Natural gas (net)	1.1	-2.2	1.4	0.8
Exports (RM million)	-5.3	21.3	7.5	40.2
<i>Of which:</i>				
Crude oil and condensates	-8.6	32.1	3.5	50.9
Liquefied natural gas	4.3	8.3	12.3	24.7

Source: PETRONAS
Department of Statistics, Malaysia

oil field. Meanwhile, natural gas production rose marginally by 0.8% during the quarter.

Continued growth momentum in the construction sector

The **construction** sector continued its growth momentum, expanding by 5.3% in the first quarter. Growth was supported by activity in the civil engineering sub-sector related to infrastructure projects in the oil and gas sector, and under the Ninth Malaysia Plan. The sector's performance was further enhanced by the non-residential segment, particularly construction of office space in the Klang Valley.

Construction Indicators				
	2007			2008
	1Q	4Q	Year	1Q
	Annual change (%)			
New sales and advertising permits	7.7	-3.1	2.0	-6.4
Housing approvals	-9.6	-6.0	-11.5	10.6
Production of construction-related materials	3.3	5.1	5.0	14.5
Loans approved for construction	81.7	27.7	54.8	73.0
Imports of construction materials and mineral products	12.6	38.8	12.9	31.6 ¹

¹ January-February 2008
Source: Ministry of Housing and Local Government and Department of Statistics, Malaysia

Domestic demand recorded a strong growth

Domestic demand recorded a strong growth of 10.1% in the first quarter (4Q 2007: 9.1%).

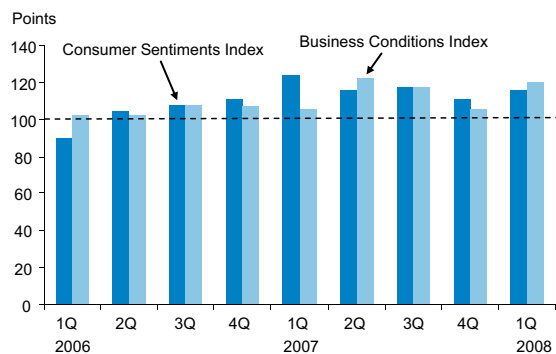
Private consumption expenditure registered a double digit growth of 11.8% for the quarter. Despite concerns of rising prices, consumer spending was supported by rising disposable income, strong export performance and favourable labour market conditions. Major consumption indicators pointed to sustained expansion in consumer spending activities during the quarter, with double-digit growth in credit card spending, sales of passenger cars, and loans approved and disbursed to households, as well as to businesses in the wholesale and retail trade sector. Reflecting consumers' continued positive outlook on the domestic economy, the MIER Consumer Sentiment Index rose to 115.5 points in the

GDP by Expenditure Components (at constant 2000 prices)

	2007			2008
	1Q	4Q	Year	1Q
	Annual change (%)			
Aggregate Domestic Demand (excluding stocks)	8.1	9.1	9.8	10.1
Consumption	7.6	8.7	9.9	11.6
<i>Private sector</i>	7.6	10.2	10.8	11.8
<i>Public sector</i>	7.3	4.2	6.6	10.5
Gross Fixed Capital Formation	9.5	10.2	9.6	6.0
Net Exports	-12.7	-12.3	-3.8	26.4
<i>Exports of Goods and Services</i>	2.4	7.8	4.2	6.0
<i>Imports of Goods and Services</i>	4.7	11.0	5.4	3.4
GDP	5.5	7.3	6.3	7.1

Source: Department of Statistics, Malaysia

Consumer Sentiment and Business Confidence Improved



first quarter (4Q 2007: 110.7 points). Similarly, **public consumption** grew by 10.5% during the quarter (4Q 2007: 4.2%) due to higher expenditure on emoluments, defence and supplies and services.

Meanwhile, **gross fixed capital formation** registered a more moderate growth of 6% in the first quarter of 2008 (4Q 2007: 10.2%). Major investment indicators suggested strong capital expenditure pattern, including robust growth in sales of commercial vehicles, loans disbursed to businesses, particularly the construction and manufacturing sectors, as well as imports of capital goods. Steady gross inflows of foreign direct investment of RM6.8 billion, especially into the manufacturing and oil and gas sectors further supported the expansion in private sector capital spending. Positive business sentiments as indicated by the MIER Business

Conditions Index which climbed to 119.9 points (4Q 2007: 105.5 points), and high capacity utilisation rates in the manufacturing sector also sustained investment growth. The Government's development expenditure continued to focus on providing essential services such as agriculture and rural development, improvement to public utilities and transport infrastructure, as well as provision of housing, education and health services.

Headline inflation rose in the first quarter of 2008

The average headline inflation increased to 2.6% during the quarter (4Q 2007: 2.2%). Prices in most categories of the Consumer Price Index (CPI) were higher compared to the previous quarter. For the food and non-alcoholic beverages category, the inflation rate was 4.4%, and it was a major contributor to the higher inflation, accounting for 1.4 percentage points of the overall inflation rate. Domestic food prices rose in response to the increase in global food prices. Prices in the restaurants and hotels category continued to increase, as prices for refreshments at restaurants and cafés increased further. Higher global prices for precious metals also pushed up prices in the miscellaneous goods and services category. The increase in overall inflation was partially mitigated by declining prices in the communication; and clothing and footwear categories, due in part to strong competition in these sectors.

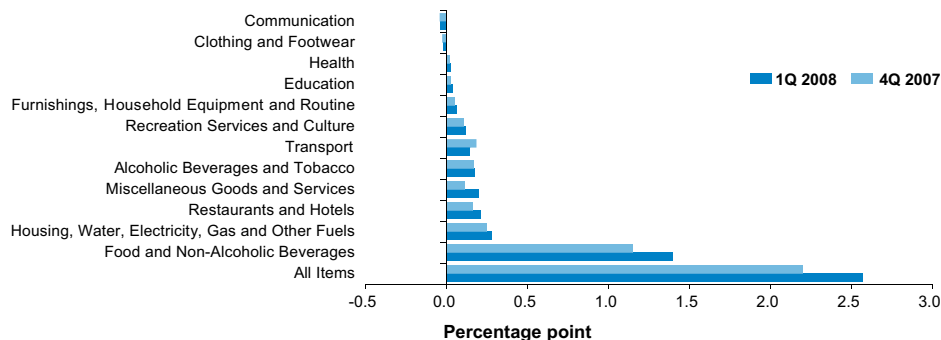
Producer price inflation remained relatively high at 9.8% (4Q 2007: 10%) signifying continued cost pressures. Prices for commodity-based Producer Price Index (PPI) components rose higher as global prices for raw commodities such as crude oil, rubber and crude palm oil continued to increase during the quarter. The non-commodity based components of the PPI did however show a moderation in price increases, especially in the machinery and transport equipment category.

Favourable labour market conditions

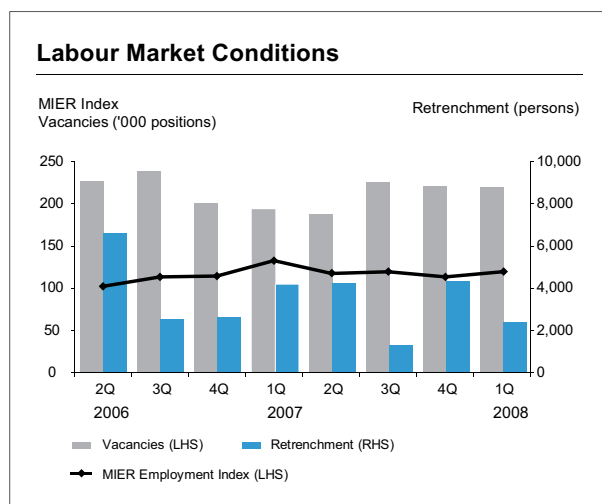
Labour market conditions tightened in the first quarter as total retrenchments declined sharply while demand for labour rose further. The MIER Employment Index increased by 6.1 points from the previous quarter to 119.2 points, suggesting continued optimism in employment prospects.

Total retrenchments fell by 45% quarter-on-quarter to 2,397 persons (4Q 2007: 4,345 persons), reflecting mainly lower retrenchments in the manufacturing and services sectors. Almost half of those retrenched involved the lower skilled workers such as plant and machine operators (27%) and general workers (22%), while professionals and technical workers accounted for another 15%. Overall, employers cited high production cost, reduction in demand and unmarketable products to be the key reasons for the retrenchments.

Contribution to Consumer Price Inflation



Meanwhile, the number of active vacancies reported via the Electronic Labour Exchange (ELX) edged upwards in the first quarter to 219,366 positions (4Q 2007: 219,179 positions), with job openings recorded mainly in the agriculture (31%), manufacturing and services (29% each) sectors. The bulk of vacancies advertised in the ELX was for elementary occupations such as labourers in the manufacturing, agriculture, construction and services sectors as well as domestic

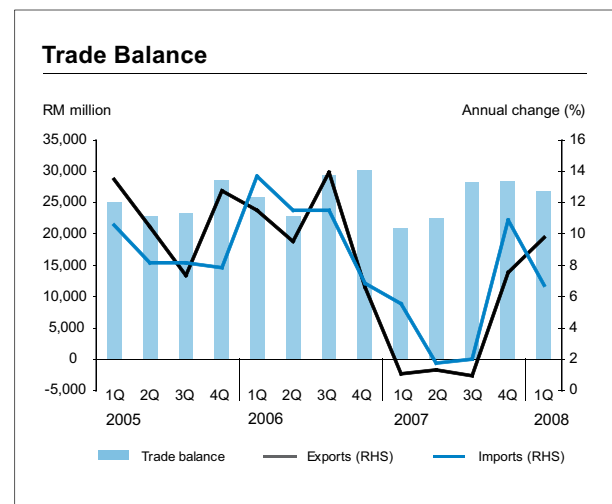


helpers and cleaners. Graduate-level vacancies increased by 48% from the previous quarter to 20,501 positions, with most jobs posted in the services sector, in particular the finance industry, real estate and business services as well as education.

Growth in real labour productivity in the manufacturing sector rebounded in the first quarter to 9.7% (4Q 2007: 0.1%) and surpassed real wage per worker growth. Labour productivity was supported by higher manufacturing sales in both domestic and export-oriented industries (23.1% and 12.6% respectively) amidst a stable headcount growth (1.3% for the whole sector). Meanwhile, growth in real wage per worker was sustained at 3.3% (4Q 2007: 3.2%), providing some support to consumption spending.

Stronger exports supported by commodities

The **trade account** recorded a surplus of RM26.8 billion in the first quarter (4Q 2007: RM28.4 billion). **Gross exports** rose by 9.8%, the fastest pace since 3Q 2006, due mainly to strong performance in commodity exports. Meanwhile, import growth moderated to 6.7% (4Q 2007: 10.9%) due mainly to slower growth in intermediate imports.



Agriculture exports performed exceptionally well during the quarter, rising by 66.2%, lifted mainly by high prices as well as higher volume of exports. In particular, export receipts from palm oil more than doubled due to record high prices (RM3,159 per tonne), as well as rising export volume (23.1%). Besides the strong fundamentals, the sharp increase in crude oil prices also attributed to the increased prices in crude palm oil and rubber.

In line with the upward trend in global crude oil prices, **mineral exports** rose by 40.2% during the quarter, reflecting the increase in export prices of Malaysian crude oil to an average of USD95.28 per barrel. Growth was further supported by a 24.7% rise in the exports of liquefied natural gas due to higher prices.

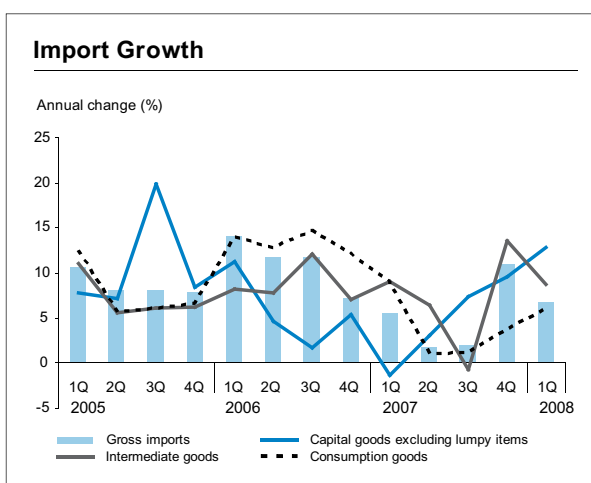
Manufacturing exports continued to expand in the first quarter, albeit at a more moderate pace of 0.8% (4Q 2007: 3%), as the robust growth in resource-based products cushioned the contraction in E&E exports. Besides the weaker demand from the major markets for semiconductors, exports of E&E products were also influenced by price attrition as reflected by the contraction in average selling prices of both semiconductors and computers and parts. Meanwhile, exports of selected resource-based products, namely petroleum, rubber and food products, registered robust performance as selling prices were influenced by the high input costs of commodities.

chemicals and chemical products, and optical and scientific equipment, improved to record a positive growth of 2.2%. Meanwhile, regional exports (excluding Japan) continued to expand strongly (9.2%), underpinned mainly by demand for non-E&E products and commodities. On the other hand, exports to the US declined further, reflecting mainly lower demand for E&E products.

Gross imports expanded at a moderate pace of 6.7% in the first quarter (4Q 2007: 10.9%), due mainly to slower growth in imports of **intermediate goods** (8.7%; 4Q 2007: 13.6%), particularly inputs for the E&E industry. Excluding lumpy items, imports of

	2007			2008
	1Q	4Q	Year	1Q
	Annual change (%)			
Gross Exports	1.0	7.6	2.7	9.8
<i>Manufacturing</i>	1.4	3.0	0.3	0.8
<i>Agriculture</i>	7.7	37.8	24.4	66.2
<i>Minerals</i>	-5.3	21.3	7.5	40.2
Gross Imports	5.5	10.9	5.0	6.7
<i>Capital goods</i>	-5.3	17.3	7.2	8.5
<i>Intermediate goods</i>	9.0	13.6	6.9	8.7
<i>Consumption goods</i>	8.9	3.8	3.6	6.0
Trade balance (RM billion)	21.1	28.4	100.3	26.8

Source: Department of Statistics, Malaysia



In the first quarter, exports to Australia and India increased significantly (37.9% and 23.7% respectively), led by strong demand for crude petroleum, refined petroleum products and E&E products. Exports to the European Union, comprising mainly exports of E&E products,

capital goods increased by 12.8% (4Q 2007: 9.6%). Increased upstream and downstream activities in the oil and gas sector led to higher imports of construction and mining equipment. Imports of machinery and office equipment

Malaysia: Direction of Exports	2007				2008	2007				2008
	1Q	4Q	Year	1Q	1Q	4Q	Year	1Q		
	Annual change (%)				Share of total exports (%)					
United States	-3.2	-15.8	-14.5	-17.6	17.2	14.3	15.6	12.9		
European Union (EU)¹	9.7	-3.2	3.6	2.2	12.8	12.5	12.9	11.9		
Selected ASEAN countries²	-4.8	15.0	1.2	13.7	25.8	26.4	25.5	26.7		
North East Asia	10.2	19.2	10.4	3.5	20.1	20.5	19.9	18.9		
<i>People's Republic of China</i>	34.6	32.5	24.3	12.5	8.1	9.5	8.8	8.3		
<i>Hong Kong SAR</i>	-15.6	13.1	-4.0	-13.7	4.6	4.7	4.6	3.6		
<i>Chinese Taipei</i>	15.4	1.6	2.6	-4.4	2.7	2.6	2.7	2.4		
<i>Korea</i>	5.9	11.5	8.2	9.4	4.7	3.7	3.8	4.7		
India	7.1	2.5	7.6	23.7	3.1	3.4	3.3	3.5		
Total exports	1.0	7.6	2.7	9.8	100.0	100.0	100.0	100.0		

¹ Refers to European Union (EU) 27 from 2007 onwards
² Singapore, Thailand, Indonesia, Philippines, Brunei Darussalam and Vietnam

Source: Department of Statistics, Malaysia

remained strong in tandem with continued investment activities in the manufacturing and services sectors. Higher demand for the festivities and positive consumer sentiment also led to higher imports of **consumption goods** (6%; 4Q 2007: 3.8%), particularly food and beverages, transport equipment as well as durable and semi-durable consumer goods.

Malaysia: Imports by End-Use ¹				
	2007			2008
	1Q	4Q	Year	1Q
	Annual change (%)			
CAPITAL GOODS	-5.3	17.3	7.2	8.5
Capital goods (except transport equipment)	-4.9	9.7	5.6	14.7
Transport equipment	-7.7	78.6	17.8	-24.7
INTERMEDIATE GOODS	9.0	13.6	6.9	8.7
Food and beverages, mainly for industry	4.0	32.4	21.0	53.3
Industrial supplies, n.e.s.	24.1	15.9	17.0	11.4
Fuel and lubricants	8.8	32.9	2.0	24.3
Parts and accessories of capital goods (except transport equipment)	2.8	6.1	0.4	-0.3
Parts and accessories of transport equipment	-18.3	37.7	11.4	32.2
CONSUMPTION GOODS	8.9	3.8	3.6	6.0
Food and beverages, mainly for household consumption	15.0	7.1	6.8	5.2
Transport equipment, non-industrial	-12.1	2.0	9.7	61.5
Consumer goods, n.e.s.	5.8	2.1	1.8	5.7
OTHERS²	5.3	11.4	5.3	7.0
GROSS IMPORTS	5.5	10.9	5.0	6.7

¹ Classified by Broad Economic Categories under the System of National Accounts
² Others refer to dual use goods, retained imports, re-exports and others.
n.e.s. Not elsewhere specified

Source: Department of Statistics, Malaysia

Continued inflows of FDI while portfolio investment remained strong

On a cash basis, gross inflows of **foreign direct investment (FDI)** amounted to RM6.8 billion in the first quarter (4Q 2007: RM12.9 billion), reflecting mainly lower drawdown of inter-company loans. The FDI inflows were mainly into the services sector (47.3%), followed by the oil and gas (20.7%) and manufacturing (19.6%) sectors. FDI in the services sector were diversified and channelled into the communication; wholesale and retail trade; finance and insurance; as well as real estate and business services sub-sectors. In the manufacturing sector, the E&E, downstream petroleum-related and paper-related industries received the bulk of the FDI inflows. After

adjustments for gross outflows due mainly to repayments of the short-term loans, net FDI amounted to RM1.7 billion (4Q 2007: RM3.4 billion). The statistics for FDI on a cash basis does not include retained earnings and investment in the form of imported machinery and equipment.

Overseas investment by Malaysian companies recorded a gross outflow of RM56.7 billion (4Q 2007: -RM20.2 billion), reflecting mainly larger short-term inter-company loans extended 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 offset largely by inflows arising from repayment of short-term inter-company loans during the quarter. After adjusting mainly for these inflows, overseas investment recorded a net outflow of RM4.9 billion (4Q 2007: -RM4.8 billion). Overseas investments were undertaken mainly by companies in the manufacturing, services, oil and gas, and construction sectors. In the manufacturing sector, overseas investment were channelled mainly into the E&E, resource-based and construction-related industries. Overseas investments in the services sector were led by investment holding companies as well as wholesale and retail trade, and real estate and business services sub-sectors. In the oil and gas sector, investments by PETRONAS were channelled mainly into its subsidiaries in West Asia, Vietnam and Africa. Meanwhile, overseas investments in the construction sector were mainly for development projects in the Middle East, South Asia and Vietnam.

Portfolio investment registered a net inflow of RM1.5 billion in the first quarter (4Q 2007: RM4.7 billion). The heightened concerns of a slowdown in the US economy and increased volatility in the global financial markets led to a net liquidation of equity securities by foreign investors. This development was broadly in line with the performance of the regional equity markets. Nevertheless, these outflows were more than offset by higher inflows of foreign funds for investment in the debt securities.

External debt remained at prudential level

Effective from the beginning of 2008, the external debt data of Malaysia has been redefined to treat entities in Labuan International Business and Financial Centre (IBFC) as residents. Under this new definition, debt exposure of these offshore entities vis-à-vis the rest of the world will be included in Malaysia's external debt while debt exposure of residents with offshore entities in Labuan IBFC are excluded. This is aimed at facilitating a strengthened risk assessment for the economy as well as to be consistent with the international standards and best practices on the treatment of offshore entities in external data compilation. Further information is provided in the Box Article "Compilation of Malaysia's External Debt: Treatment of Offshore Entities in Labuan International Business and Financial Centre as Residents".

As at end-March 2008, Malaysia's external debt position amounted to RM212.8 billion or USD65.9 billion (end-2007: RM211.2 billion or USD63.1 billion), equivalent to 31.1% of GNI. The **medium- and long-term external debt** was lower (RM132.4 billion; end-2007: RM134 billion) as the exchange revaluation gain arising

from the appreciation of ringgit against major currencies, particularly the US dollar, and net repayment by the Federal Government more than offset the net loan drawdown by the NFPEs. The net loan drawdown of RM1.5 billion by the NFPEs was largely by companies in the finance and insurance subsector as well as electricity, gas and water sector.

The total **short-term external debt** increased marginally to RM80.4 billion or USD24.9 billion (end-2007: RM77.2 billion or USD23.1 billion) due mainly to the inter-bank borrowings, particularly by the offshore financial entities in Labuan IBFC for treasury operations. As at end-March 2008, the short-term debt remained low and is 20.9% of the net international reserves.

External Debt Outstanding

	2007	2008
	4Q	1Q ^P
	RM billion	
Medium- and long-term debt	134.0	132.4
Public sector	74.2	74.5
Private sector	59.8	57.9
Short-term debt ¹	77.2	80.4
Total external debt	211.2	212.8
- USD billion equivalent	63.1	65.9

¹ Excludes currency and deposits held by non-residents with resident banking institutions
^P Preliminary

Source: Ministry of Finance, Malaysia and Bank Negara Malaysia

Compilation of Malaysia's External Debt: Treatment of Offshore Entities in Labuan International Business and Financial Centre as Residents

As part of the continuous efforts to improve the compilation and dissemination of external debt data in conformity with the international standards and best practices¹, the external debt data of Malaysia has been redefined to treat entities in Labuan International Business and Financial Centre (IBFC) as residents starting with the first quarter of 2008. Under this new definition, debt exposure of these offshore entities vis-à-vis the rest of the world will be included in Malaysia's external debt while debt exposure of residents with offshore entities in Labuan IBFC are excluded.

The treatment of offshore entities in Labuan IBFC as residents is strictly applicable only to the external debt data compilation. The offshore entities in Labuan IBFC would continue to be treated as non-residents for foreign exchange administration purposes, and thus, are not subject to foreign exchange administration rules that are applicable to residents.

Implication on Malaysia's External Debt

Table 1 provides a comparison of Malaysia's external debt position with offshore entities in Labuan IBFC being treated as non-residents (old definition) and as residents (new definition). Under the new definition, Malaysia's total external debt as at end-2007 was marginally higher at RM211.2 billion (equivalent to USD63.1

billion) or 33.6% of GNI, compared with RM187.4 billion (equivalent to USD56 billion) or 29.9% of GNI under the old definition. The profile of the external debt continued to be skewed towards a longer maturity structure, with medium- and long-term external debt accounting for 63.4% of the total external debt.

**Table 1:
External Debt Outstanding**

	Offshore Entities in Labuan IBFC as		
	Non-Resident	Resident (new definition)	
	RM billion		
	End-4Q 07	End-4Q 07	End-1Q 08 ^P
Total external debt (ED)	187.4	211.2	212.8
<i>(USD billion equivalent)</i>	<i>56.0</i>	<i>63.1</i>	<i>65.9</i>
Medium- and long-term (MLTD)	133.0	134.0	132.4
<i>Federal Government</i>	<i>19.6</i>	<i>18.7</i>	<i>18.2</i>
<i>NFPEs</i>	<i>41.9</i>	<i>55.5</i>	<i>56.3</i>
<i>Private Sector</i>	<i>71.5</i>	<i>59.8</i>	<i>57.9</i>
<i>Bank</i>	<i>1.4</i>	<i>13.2</i>	<i>12.3</i>
<i>Non-bank</i>	<i>70.1</i>	<i>46.6</i>	<i>45.6</i>
Short-term (STD) ¹	54.5	77.2	80.4
<i>Bank</i>	<i>42.1</i>	<i>69.9</i>	<i>73.5</i>
<i>Non-bank</i>	<i>12.3</i>	<i>7.3</i>	<i>6.9</i>
	(percent)		
ED/GNI	29.9	33.6	31.1
STD/ED	29.1	36.6	37.8
STD/Reserves	16.2	23.0	20.9

¹ Excludes currency and deposits held by non-residents with resident banking institutions
^P Preliminary

The larger external debt under the new definition reflected mainly higher short-term inter-bank borrowings of offshore financial entities in Labuan IBFC arising from their loan extension, investment activities and treasury operations. Despite an increase in the short-term debt, the ratio of Malaysia's short-term debt to reserves remained low at 23% (16.2% under old definition).

¹ The Fifth Edition of the Balance of Payments Manual (BPM 5) of the IMF classifies offshore entities in an economy as residents for compilation of external data, including external debt data. Similarly, the External Debt Statistics Guide for Compilers and Users (2003), also states that 'The residence of offshore enterprises—including those engaged in the assembly of components manufactured elsewhere, those engaged in trade and financial operations, and those located in special zones—is attributed to the economies in which they are located.' As such, the debt liabilities of offshore entities that are owed to non-residents are to be included as part of an economy's external debt.

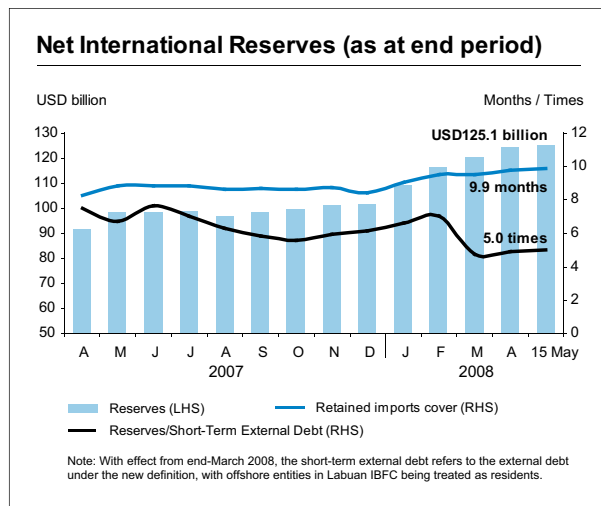
Of significance, the short-term debt of the non-bank private sector was lower at RM7.3 billion and accounted for only 9.5% of the total short-term external debt.

The medium- and long-term external debt was marginally higher at RM134 billion (equivalent to USD40 billion) under the new definition (RM133 billion or USD39.7 billion

under old definition), as the inclusion of borrowings by offshore entities (including by subsidiaries of NFPEs operating in Labuan IBFC) from non-residents more than offset lower external borrowings by the Federal Government and non-bank private sector following the reclassification of loans sourced from the offshore entities in Labuan IBFC as part of domestic borrowing.

International reserves

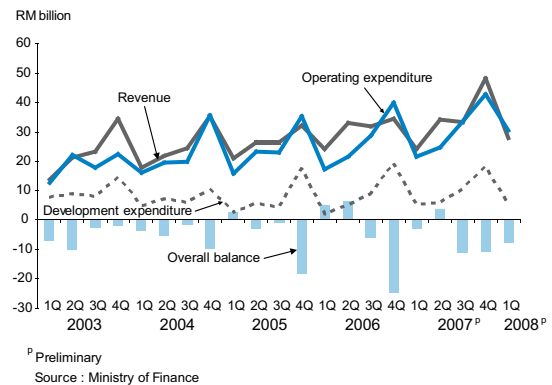
The **international reserves** of Bank Negara Malaysia amounted to RM384.7 billion (equivalent to USD120.3 billion) as at 31 March 2008. The reserves level as at 31 March 2008 has taken into account the quarterly adjustment of the foreign exchange revaluation loss, following the strengthening of ringgit against the major currencies during the first quarter. The reserves increased to RM399.9 billion (equivalent to USD125.1 billion) as at 15 May 2008. The reserves position is sufficient to finance 9.9 months of retained imports and is 5 times the short-term external debt.



Higher Federal Government spending

In the first quarter of 2008, total expenditure rose at an annual rate of 32.3%, due mainly to higher emoluments and the transfer of funds to statutory bodies, as reflected by the higher operating expenditure (1Q 2007: 38.7%). At the same time, the bulk of the development expenditure continued to be channelled to the economic and social services sectors. The Federal Government's revenue also grew during the quarter as a result of better revenue collection. During the quarter, the Federal

Federal Government Finance



Federal Government Finance^P

	2007			2008
	1Q	4Q	Year	1Q
	RM billion			
Revenue	24.2	48.2	139.9	28.0
% growth	0.1	40.0	13.2	15.4
Operating expenditure	21.7	42.9	123.1	30.4
% growth	25.2	7.3	14.3	40.3
Current account	2.5	5.3	16.8	-2.5
% of GDP	1.8	3.0	2.6	-1.4
Gross development expenditure	5.3	18.2	40.6	5.3
% growth	148.4	-6.0	13.3	-0.3
Overall balance	-2.6	-10.5	-20.7	-7.7
% of GDP	-1.8	-5.9	-3.2	-4.4
Memo item:				
Total gross expenditure	27.0	61.1	163.6	35.7
% growth	38.7	3.0	14.0	32.3
Total Federal Government debt (as at end-period)	250.0	266.7	266.7	275.1
% of GDP	39.0	41.6	41.6	39.3
Domestic debt	225.9	247.1	247.1	256.8
% of GDP	35.2	38.5	38.5	36.7
External debt	24.1	19.6	19.6	18.2
% of GDP	3.8	3.1	3.1	2.6

^P Preliminary

Government's financial position recorded a fiscal deficit of RM7.7 billion (4.4% of GDP). The deficit was financed mainly from domestic borrowings. As at end-March 2008, total outstanding debt of the Federal Government amounted to RM275.1 billion or 39.3% of the estimated 2008 GDP.

MONETARY AND FINANCIAL DEVELOPMENTS

Interest rates were stable

The OPR was left unchanged at 3.50% throughout the first quarter of 2008, as the prevailing level of the policy rate remained consistent with the outlook for economic growth and inflation.

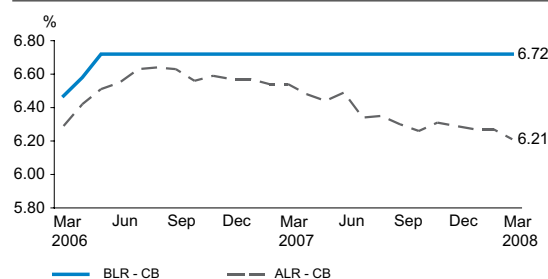
Concurrently, the daily weighted average overnight interbank rate moved within a narrow range of 3.49% - 3.51%. Interbank rates of other maturities were also relatively stable during the quarter.

In terms of lending rates, the average base lending rate (BLR) of commercial banks (CBs) was unchanged at 6.72%. The average lending rate (ALR) on the other hand softened to 6.21% as at end-March, compared with 6.29% as at end-2007, due to competition amidst ample liquidity conditions. The average quoted fixed deposit (FD) rates of CBs for tenures of between 1 to 12 months were relatively unchanged, ranging between 3.08% and 3.70% at the end of the first quarter.

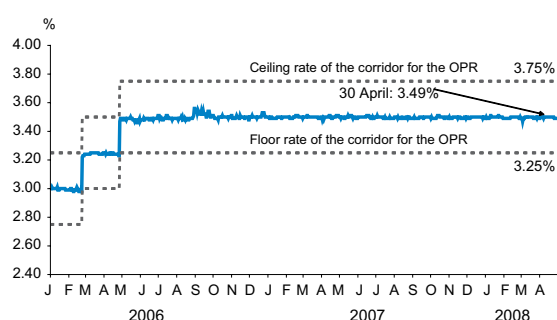
Interest Rates

	2007		2008
	1Q	4Q	1Q
At end-period (%)			
Overnight Policy Rate (OPR)	3.50	3.50	3.50
Interbank rates			
Overnight	3.50	3.50	3.50
1-month	3.55	3.54	3.55
Base lending rates (BLR)			
Commercial banks	6.72	6.72	6.72
Average lending rates (ALR)			
Commercial banks	6.54	6.29	6.21
Fixed deposit rates			
Commercial banks			
3-month	3.18	3.15	3.14
12-month	3.71	3.70	3.70

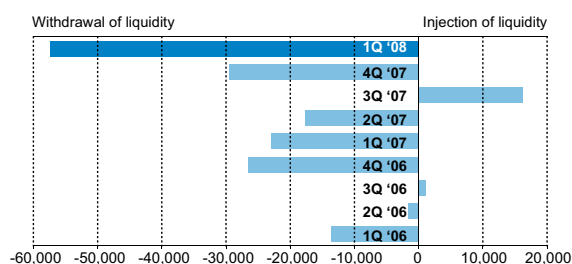
Lending Rates of Commercial Banks (Average for the period)



Daily Weighted Average Overnight Interbank Rate



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



M3 expanded at a faster pace

M3, or broad money, expanded significantly by RM51.6 billion during the first quarter. Consequently, there was a turnaround in the trend of the growth in broad money, which after moderating to 9.5% at the end of 2007, increased to 12.1% at end-March 2008. Growth in M3 was underpinned by the strong increase in inflows during the first quarter, stemming from higher export proceeds, foreign direct investment and portfolio investment. The expansion in M3 was also supported by the significant increase in lending to the private sector and to a lesser extent, expansionary Government operations.

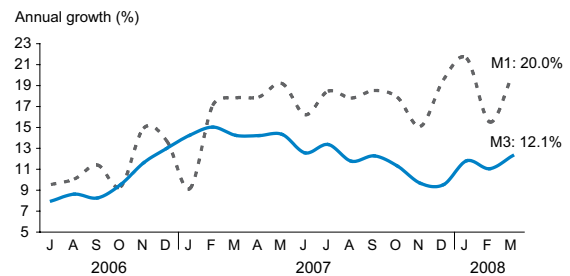
“Other influences” on the other hand were contractionary on M3, mainly reflecting Bank Negara Malaysia’s sterilisation operations, which limited the impact of the inflows on broad money expansion.

Similarly, M1, a measure of transactional balances, rose at an annual rate of 20% at end-March 2008 (end-2007: 19.6%), reflecting the increase in both currency in circulation and demand deposits.

Gross private sector financing remained strong

Financing activity in the first quarter remained strong in support of domestic economic activity. Despite the global financial turmoil, domestic credit conditions remained favourable, with demand for financing supported by ample liquidity in the domestic financial system. The cost of financing also

Monetary Aggregates



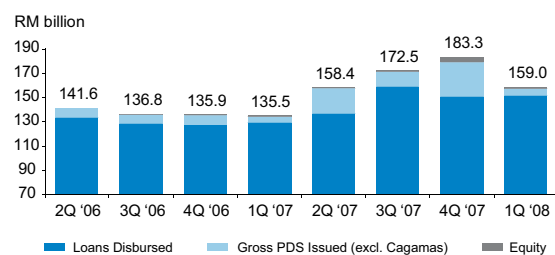
Determinants of Broad Money, M3

	Change during the period			
	2007			2008
	1Q	4Q	Year	1Q
	RM billion			
M3	28.9	28.5	72.5	51.6
Net claims on Government	1.0	8.5	-0.6	1.7
Claims on private sector	5.2	-3.3	50.9	17.3
Loans	8.1	-3.1	48.4	16.3
Securities	-2.9	-0.2	2.5	0.9
Net external operations ¹	37.3	20.7	77.0	45.7
BNM	19.9	7.2	50.9	52.5
Banking system	17.5	13.5	26.1	-6.8
Other influences	-14.7	2.7	-54.8	-13.0

¹ Pre-revaluation

Source: Bank Negara Malaysia

Gross Private Sector Financing through Banking System and Capital Market



Financing of the Private Sector through Banking System and Capital Market

	During the period (RM billion)				Annual growth (%)		
	2007	1Q 07	4Q 07	1Q 08	2007	4Q 07	1Q 08
Gross total financing	649.6	135.5	183.3	159.0	17.6	34.9	17.4
Loans disbursed*	575.9	129.2	150.7	151.4	10.8	18.5	17.2
Gross PDS (excl. Cagamas)	66.5	5.1	28.7	6.5	116.4	255.0	26.6
Equity	7.1	1.1	3.8	1.1	272.0	504.0	-2.2
Outstanding total financing (A)+(B)	84.0	6.2	19.5	22.8	10.7	10.7	12.7
Banking system	59.7	7.6	5.0	17.8	9.3	9.3	10.8
<i>Loans outstanding (A)</i>	51.2	8.5	-0.7	17.4	8.6	8.6	10.0
<i>Holding of PDS</i>	8.5	-0.9	5.7	0.5	17.6	17.6	20.9
PDS outstanding (B)	32.7	-2.3	20.2	5.5	17.1	17.1	21.4
Memorandum item							
Gross PDS (incl. Cagamas)	31.7	6.2	28.7	10.0	113.0	255.0	60.0

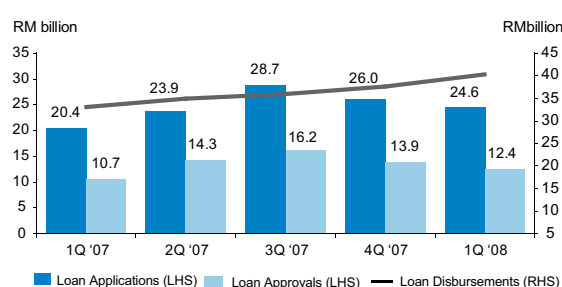
* Banking system loans include loans sold to Cagamas

remained low. As a result, on a net basis, banking system loans and PDS outstanding expanded at a faster pace of 12.7% at end-March (end-2007: 10.7%). Gross financing raised by the private sector from the banking system and capital market increased at a more moderate pace of 17.4% after the significant expansion in the fourth quarter of 2007 (4Q 2007: 34.9%), which reflected the large issuance of PDS by one firm to refinance a bridging loan contracted earlier in 2007.

Of significance, loans outstanding increased markedly by 10% at end-March (end-2007: 8.6%). The strong expansion in loans outstanding was due to both the business and household sectors, with loans outstanding to these sectors expanding at higher annual rates of 11.6% and 8% respectively (end-2007: 10.4% and 7.4% respectively).

The favourable loans performance was underpinned by robust growth in loan disbursements. Loan disbursements were broad-based. In particular, financing channelled

Bank Lending to SMEs



to SMEs has increased consistently since 2005 and currently accounts for 26.6% (4Q 2007: 25%) of total loan disbursements. In the household sector, funds were mainly distributed for the purchase of residential property, passenger cars and personal use.

Given the absence of large scale merger and acquisition activity, loan applications and approvals have returned to more moderate levels. On an annual basis, however, loan applications and approvals continued to register strong growth rates.

Loan Indicators

	During the period (RM billion)				Annual Growth (%)			
	2007	1Q 07	4Q 07	1Q 08	2007	1Q 07	4Q 07	1Q 08
Total								
Loan applications	457.5	83.5	131.2	112.1	52.1	21.5	71.0	34.2
Loan approvals	298.6	53.1	87.9	72.1	58.6	20.4	77.1	35.7
Loan disbursements	575.9	129.2	150.7	151.4	10.8	-1.4	18.5	17.2
Loan repayments	518.6	118.0	153.8	138.8	8.4	-0.1	25.6	17.6
Change in loan outstanding*	51.2	8.5	-0.7	17.4	8.6	6.2	8.6	10.0
Of which:								
Business enterprises**								
Loan applications	262.6	44.9	77.3	56.5	63.1	24.2	87.3	25.8
Loan approvals	181.5	29.8	56.7	38.5	88.4	39.5	101.8	29.0
Loan disbursements	406.3	90.3	105.6	106.3	9.9	-3.9	17.8	17.7
Loan repayments	370.1	81.6	115.0	97.4	5.3	-6.2	30.2	19.3
Change in loan outstanding*	24.6	4.2	-9.9	7.6	10.4	6.1	10.4	11.6
SMEs**								
Loan applications	99.1	20.4	26.0	24.6	38.8	55.2	31.5	20.5
Loan approvals	55.1	10.7	13.9	12.4	37.1	36.1	17.0	16.0
Loan disbursements	141.5	33.0	37.6	40.3	5.5	10.8	13.3	22.3
Loan repayments	126.6	29.3	34.5	35.1	3.4	16.0	10.1	19.8
Change in loan outstanding*	9.5	2.7	2.3	4.6	9.1	6.0	9.1	10.7
Large corporations								
Loan applications	163.5	24.5	51.3	31.9	82.4	6.5	138.7	30.1
Loan approvals	126.4	19.2	42.9	26.1	125.2	41.6	163.6	36.2
Loan disbursements	264.8	57.3	68.1	66.0	12.4	-10.8	20.4	15.1
Loan repayments	243.5	52.3	80.5	62.3	6.3	-15.3	41.3	19.1
Change in loan outstanding*	15.1	1.5	-12.3	2.9	11.4	6.2	11.4	12.3
Households								
Loan applications	194.9	38.6	53.9	55.6	39.4	18.4	51.9	44.0
Loan approvals	117.1	23.3	31.2	33.6	27.3	2.3	44.8	44.4
Loan disbursements	169.6	38.9	45.0	45.1	12.9	5.0	20.2	16.0
Loan repayments	148.5	36.4	38.8	41.4	17.3	17.0	13.8	13.9
Change in loan outstanding*	24.5	3.9	6.7	6.2	7.4	7.7	7.4	8.0

* The annual growth is for end-period

** Include loans to individual businesses

Source: Bank Negara Malaysia

Loans by Sector

	Loans disbursed					Loans out- standing	
	During the period				Share of total	Share of total	
	2007	1Q 07	4Q 07	1Q 08			
	(RM billion)				(%)		
Business enterprises	406.3	90.3	105.6	106.3	70.2	40.7	
Large corporations	264.8	57.3	68.1	66.0	43.6	22.7	
SMEs*	141.5	33.0	37.6	40.3	26.6	18.0	
<i>Selected sectors</i>							
Agriculture, hunting, forestry and fishing	14.1	3.1	3.6	3.7	2.4	2.2	
Mining and quarrying	2.0	0.3	0.7	0.5	0.3	0.2	
Manufacturing	135.1	32.5	35.3	36.2	23.9	11.6	
Construction	32.6	7.6	8.4	9.3	6.1	5.1	
Real estates	12.3	2.4	3.6	4.1	2.7	3.3	
Electricity, gas and water supply	1.3	0.3	0.4	0.8	0.5	0.7	
Wholesale, retail, restaurants and hotels	91.9	20.5	25.8	25.2	16.6	8.7	
Transport, storage and communication	32.2	2.5	5.6	2.7	1.8	2.3	
Finance, insurance and business services	45.7	10.3	11.9	14.3	9.5	6.3	
Households	169.6	38.9	45.0	45.1	29.8	54.7	
Purchase of residential properties	39.9	8.5	11.1	10.5	6.9	26.1	
Consumption credit	109.5	25.4	29.3	29.4	19.4	22.0	
<i>Of which:</i>							
Credit cards	57.9	13.7	15.4	14.7	9.7	3.4	
Purchase of passenger cars	27.8	6.4	7.4	8.4	5.6	14.4	
Others	20.2	5.1	4.6	5.3	3.5	6.6	
Total	575.9	129.2	150.7	151.4	100.0	100.0	

* Include loans to individual businesses.

Source: Bank Negara Malaysia

Higher financing from the capital market

Total net funds raised from both the public and private sectors were significantly higher at RM12.4 billion (4Q 2007: +RM567 million).

The public sector raised gross funds of RM16.3 billion through the issuance of a 5-year Malaysian Government Securities (MGS), the 3-year callable MGS, two re-openings of the 3-year and 10-year MGS and a new issue of Government Investment Issues (GII). After adjusting for redemptions, net funds raised by the public sector were higher at RM10.6 billion.

In the private sector, gross funds raised from the PDS market moderated in the first quarter to RM10 billion (4Q 2007: RM28.7 billion). During the quarter, there were also issuances by four non-resident quasi-sovereign and multinational corporations in the Malaysian capital market, amounting to RM3.5 billion. On a net basis, funds raised through the PDS market amounted to RM700 million during the quarter.

Funds raised through the equity market were lower during the first quarter, amounting to RM1.1 billion. A total of RM232 million was raised through seven initial public offerings (IPOs); four on the Second Board and three on MESDAQ, while the remaining was raised through rights issues and warrants.

Higher secondary trading in the bond market

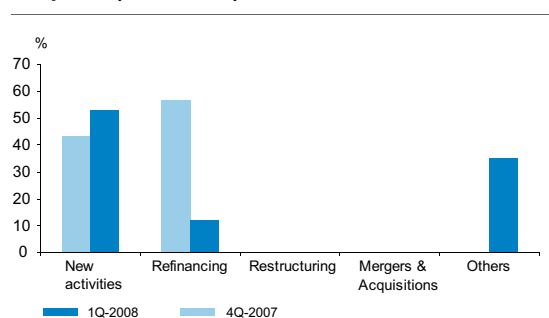
Total trading in the secondary market rose to RM102.3 billion in the first quarter (4Q 2007: RM79.6 billion). Government securities (MGS and GII) accounted for 80% of the total trade, followed by private debt securities with 19% of total trade. In terms of liquidity, the MGS was the most liquid paper, registering a liquidity ratio of 0.38, followed by the GII with a liquidity ratio of 0.18.

In the month of January 2008, the MGS benchmark yields declined significantly between 16 – 49 basis points. The downward shift in the yield curve was mainly due to the rebuilding of

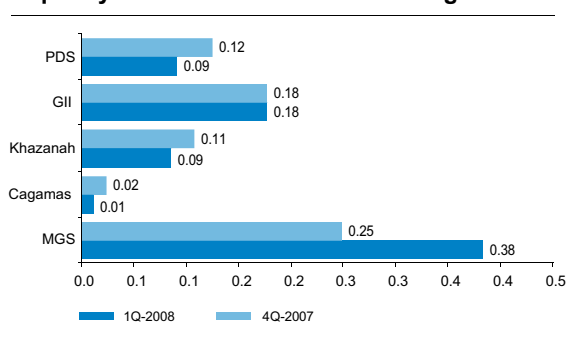
Funds Raised in the Capital Market

	2006	2007		2008	
	Year	1Q	4Q	Year	
	RM million				
By Public Sector	20,919	7,431	(5,946)	25,178	10,633
Government Securities, <i>net</i>	23,480	8,809	(5,552)	27,187	10,633
<i>Malaysian Government Securities</i>	26,830	10,109	14,048	43,187	14,283
<i>Government Investment Issues</i>	9,500	3,500	-	10,000	2,000
<i>Less: Redemptions</i>	12,850	4,800	19,600	26,000	5,650
Khazanah Bonds, <i>net</i>	(630)	(1,020)	-	(496)	-
Merdeka Savings Bond, <i>net</i>	(1,931)	(358)	(394)	(1,513)	-
By Private Sector	9,284	2,318	6,513	20,300	1,802
Shares	1,916	1,126	3,819	7,126	1,101
Debt securities, <i>net</i>	7,368	1,192	2,694	13,174	700
<i>Private Debt Securities</i>	31,737	6,232	28,746	67,606	9,969
<i>Cagamas</i>	7,150	1,350	-	1,750	-
<i>Less: Redemptions</i>	31,519	6,390	26,052	56,182	9,268
Total	30,203	9,749	567	45,478	12,435

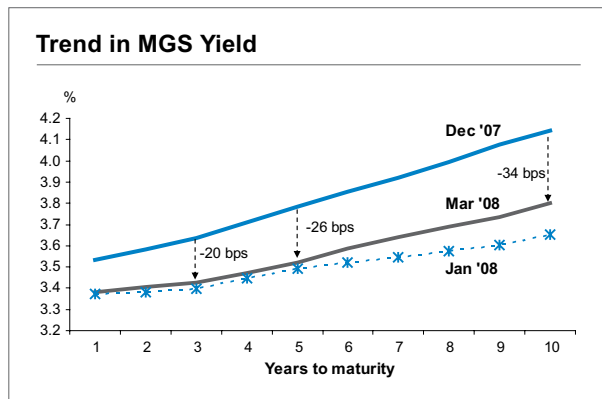
Private Debt Securities Issued by Purpose (% of total)



Liquidity Ratio: Turnover / Outstanding



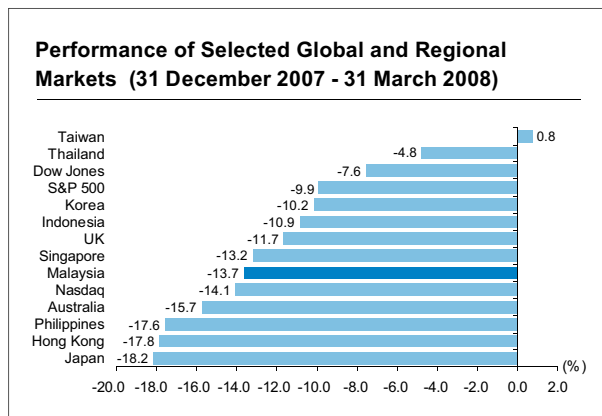
portfolios by investors in the early part of the year and the strengthening of the ringgit, which influenced buying momentum in the market. However, since mid-February, MGS yields have been gradually trending upwards especially in the longer-tenures on concerns over higher



domestic inflation. Overall, the quarterly yield spreads for the 3-year, 5-year and 10-year MGS declined by 20, 26 and 34 basis points respectively.

KLCI affected following developments in global financial markets

The Kuala Lumpur stock market began the first quarter on a positive note with the KLCI rising to a new high of 1,516.2 on 11 January 2008 due to the strong performance of the plantations sector arising from the higher crude palm oil



prices. Subsequently, the KLCI weakened in line with regional equity markets on renewed concerns over the depth of the US economic slowdown and domestic developments. Nonetheless, the implementation of policy measures by the US Federal Reserve to ease the tight liquidity conditions in credit markets, and the cumulative reduction in the Fed Funds rate by 200 basis points within the first quarter, have restored to some extent stability in the global equity markets. The KLCI ended the first quarter at 1,247.5 (since end-2007: -13.7%). Market capitalisation was lower at RM952.3 billion (since end-2007: -13.9%) and trading activity decreased to a daily average turnover of 930.4 million units (since end-2007: -26.7%).

On 26 May 2008, the KLCI closed at 1,273.4 (since end-2007: -11.9%), with market capitalisation lower at RM971.4 billion (since end-2007: -12.2%).

Bursa Malaysia: Selected Market Indicators

	As at end			
	2007			2008
	1Q	4Q	Year	1Q
Price Indices				
Composite	1,246.9	1,445.0	1,445.0	1,247.5
FBM30 ¹	7,924.6	9,343.7	9,343.7	8,232.9
FBMEMAS ²	8,332.8	9,810.8	9,810.8	8,423.7
Second Board	99.3	-	-	-
Mesdaq	138.5	-	-	-
FTSE Second Board	-	6,732.4	6,732.4	5,884.6
FTSE Mesdaq	-	6,109.2	6,109.2	4,923.2
Average daily turnover				
Volume (million units)	2,078.5	1,268.5	1,548.4	930.4
Value (RM million)	2,765.7	1,898.7	2,345.7	2,035.2
Market capitalisation (RM billion)	985.1	1,106.2	1,106.2	952.3
No. of companies listed	1,023	987	987	989

¹ FBM30 stands for FTSE Bursa Malaysia 30 Index
² FBMEMAS stands for FTSE Bursa Malaysia EMAS Index

Source: Bursa Malaysia

Bursa Malaysia: Turnover of Corporate Securities

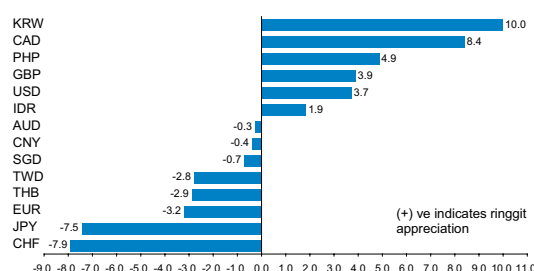
	2007						2008	
	1Q		4Q		Year		1Q	
	million units	RM million	million units	RM million	million units	RM million	million units	RM million
Turnover	123,632	164,163	78,648	117,720	382,846	579,684	53,982	145,481
Of which:								
Main Board	90,866	144,661	50,667	106,134	270,525	519,033	36,488	137,875
Of which:								
Consumer Products	1,959	5,130	1,752	4,777	7,790	20,344	931	4,627
Industrial Products	9,174	12,524	4,906	8,213	29,512	44,796	3,409	9,086
Construction	7,688	17,770	3,486	9,748	22,772	57,378	4,722	15,929
Trading/Services	20,975	46,296	15,545	38,069	72,166	177,366	10,383	48,862
Finance	9,316	28,825	3,728	17,445	23,623	89,857	3,391	26,425
Properties	16,818	12,045	7,300	7,814	50,140	48,528	4,234	6,386
Plantations	1,451	8,639	2,177	9,658	7,509	37,186	2,262	17,449
Infrastructure	1,685	3,612	1,408	4,694	6,278	15,375	1,148	4,534
Second Board	8,762	5,214	7,254	4,707	34,671	23,765	4,118	3,689
Mesdaq	17,731	8,846	6,139	3,050	43,098	23,691	5,621	2,845

Source: Bursa Malaysia

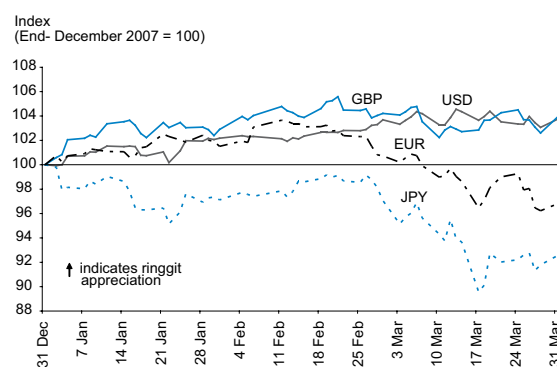
Exchange Rate Developments

The ringgit experienced greater two way movements during the first quarter, reflecting volatile portfolio flows as investors reacted to events related to the turbulence in the international financial markets, and reassessed their positions on concerns that the US economic slowdown would have a spillover effect upon the region. The upward trend of the ringgit against the US dollar during this period was also supported by the positive investor sentiment on the Malaysian economy following the release of strong GDP growth numbers for 2007 on 27 February 2008. It also reflected the weakness of the US dollar arising from the deteriorating fundamentals of the US economy. During the quarter, the ringgit appreciated against the US dollar by 3.7% and the pound sterling by 3.9%, but depreciated against the Japanese yen and the euro by 7.5% and 3.2% respectively. The ringgit also recorded a mixed performance against regional currencies during the first quarter, appreciating against the Korean won (10.0%), Philippine peso (4.9%) and the Indonesian rupiah (1.9%), but depreciating against the Thai baht (-2.9%), the Singapore dollar (-0.7%) and the Chinese renminbi (-0.4%).

Summary of Ringgit Performance Against Selected Currencies Percent Change (1 January - 31 March 2008)



Ringgit Performance Against Major Currencies



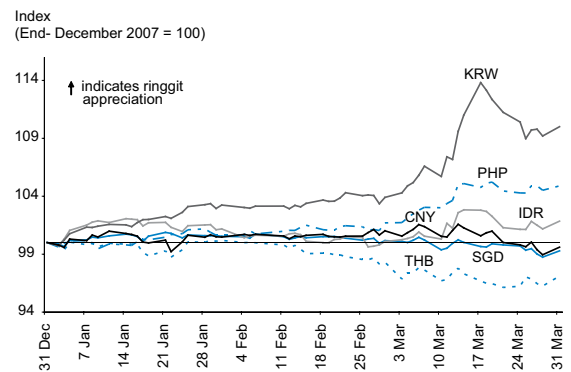
Performance of Ringgit Against Selected Currencies

RM per foreign currency	As at end				% change since*		
	21 Jul 05	1Q 07	4Q 07	1Q 08	21 Jul 05	1Q 07	4Q 07
US dollar	3.8000	3.4560	3.3065	3.1875	19.2	8.4	3.7
Euro	4.6212	4.6105	4.8756	5.0369	-8.3	-8.5	-3.2
Pound sterling	6.6270	6.7867	6.6070	6.3586	4.2	6.7	3.9
100 Japanese yen	3.3745	2.9339	2.9534	3.1912	5.7	-8.1	-7.5
Singapore dollar	2.2570	2.2781	2.2938	2.3102	-2.3	-1.4	-0.7
100 Thai baht	9.0681	9.8785	9.8159	10.108	-10.3	-2.3	-2.9
100 Philippine peso	6.8131	7.1649	8.0158	7.6421	-10.8	-6.2	4.9
100 Indonesian rupiah	0.0386	0.0379	0.0352	0.0346	11.6	9.6	1.9
100 Korean won	0.3665	0.3674	0.3532	0.3211	14.1	14.4	10.0
Chinese renminbi	0.4591	0.4471	0.4527	0.4545	1.0	-1.6	-0.4

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

During the period 1 April to 27 May 2008, the ringgit depreciated against the US dollar (-1.9%), the euro (-1.8%) and the pound sterling (-1.2%), but appreciated against the Japanese yen (1.5%). The ringgit recorded a mixed performance against regional currencies, appreciating against the Korean won (3.2%), the Philippine peso (2.8%) and the Thai baht (0.6%) but depreciating against the Singapore dollar (-3.2%), the Chinese renminbi (-2.9%) and the Indonesian rupiah (-0.4%).

Ringgit Performance Against Regional Currencies



DEVELOPMENTS IN THE BANKING SECTOR

The banking sector continued to exhibit high resilience in the first quarter of 2008, supported by strong capitalisation and profitability. Coupled with the continued decline in the level of non-performing loans (NPLs), banking institutions are well-positioned to continue to support economic activities.

Banking system remained well-capitalised

The banking system risk-weighted capital ratio (RWCR) and core capital ratio (CCR) stood at 13.2% and 10.2% respectively following implementation of the Basel II Standardised Approach effective 1 January 2008. During the quarter, capital base expanded by 3.5% following the establishment of an Islamic banking subsidiary and an investment bank as well as issuance of subordinated debt.

	2007				2008
	1Q	2Q	3Q	4Q	1Q
Capital					
CCR (%)	10.4	10.8	10.3	10.2	10.2
RWCR (%)	13.1	13.9	13.2	13.2	13.2

Sustained profitability from diversified income sources

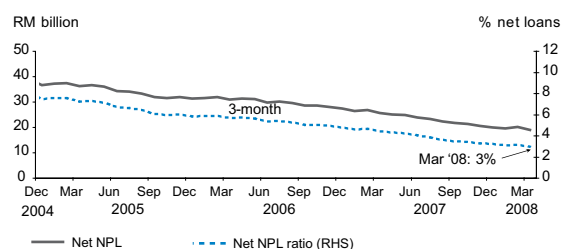
During the quarter, the banking system registered a growth of 7.1% in unaudited pre-tax profit (PBT) to RM5.7 billion (4Q 2007: RM5.3 billion). The PBT level remained stable

on account of continued revenue generated from financing-related activities and wealth management services. Consequently, the annualised average returns on asset and equity improved to 1.8% (4Q 2007: 1.5%) and 23.5% (4Q 2007: 19.8%) respectively.

Continued decline in the level of NPLs

The NPL level of the banking system continued to improve during the quarter. Total net NPLs based on the 3-month classification declined further by 5.2% to RM19 billion (4Q 2007: RM20.1 billion) to account for 3% of total net loans (4Q 2007: 3.2%). This was attributed mainly to the continued recoveries and reclassifications of NPLs to performing status as well as write-offs during the quarter. The NPL ratio has improved further to 2.9% as at 30 April 2008.

Banking System: Non-performing Loans



**Seminar on Islamic Finance
Jointly Organized by
Islamic Financial Services Board & Hong Kong Monetary Authority
“Towards Gaining Global Growth Potential of Islamic Finance”
Hong Kong, 15 January 2008**

by

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

It is my honour and great pleasure to be in Hong Kong today to speak at this seminar on Islamic Finance jointly organised by the Hong Kong Monetary Authority and the Islamic Financial Services Board. Islamic finance is now at the threshold of a new dimension in which, it has now an increased potential to strengthen international financial linkages between nations. And in so doing, it would contribute towards a more optimum allocation of financial resources across borders. Hong Kong, with its sophisticated financial infrastructure and high level of expertise in the financial sector, has strong potential to be an important linkage and an engaging partner in the international Islamic financial activity.

It is exactly six years ago that we were here in Hong Kong as our first destination, to promote the world’s first sovereign sukuk issuance. The overwhelming response we received in Hong Kong provided the momentum effect that resulted in the successful issuance of the pioneering USD600 million Malaysian sovereign sukuk. It was more than two times over subscribed with one-third of the investors from this region. Six years hence, the Islamic financial landscape has been dramatically transformed into a vibrant, dynamic and competitive global intermediation mechanism that is supported by more than 300 Islamic financial institutions in more than 75 countries. It also has become among the fastest growing segments in the financial services industry.

In the early phase of its development, Islamic finance was essentially domestic centric, focussing on retail financing, trade financing and the financing of other commercial business activities. Two recent developments have

however, influenced the subsequent direction of the development of Islamic finance.

Firstly, the drive to diversify the domestic financial infrastructure so as to avoid the over dependence on the banking sector and secondly, the trend towards greater liberalisation of the financial system. These two trends have spurred the development of the Islamic financial markets and its greater integration into the international financial system, thereby raising the international dimension of Islamic finance.

This more dynamic environment, has fostered the generation of a wide spectrum of Islamic financial instruments that has ranged from instruments to manage liquidity to structures for the financing of that for financing mega investments. These developments have led to the emergence of a new asset class. It has also drawn a higher level of foreign participation in the Islamic financial markets which has resulted in increased cross-border flows. This has not only contributed to enhancing international financial inter-linkages between economies but it has also contributed towards the more efficient allocation of financial resources across borders.

Islamic finance in 2008 and beyond remains positive despite the current challenging global financial environment. The viability and competitiveness of Islamic finance is derived from several factors. It is from its ability to meet the changing demands of the economy, from its cost competitiveness and from being supported by a well developed legal, regulatory and supervisory framework. But more importantly, are the fundamental Shariah requirements of Islamic finance that support its viability and stability.

Shariah is the key pillar of Islamic finance from which Islamic finance derives its unique characteristics. The Shariah injunctions require that Islamic financial transactions be accompanied by an underlying productive activity. In Islamic finance, there is always a close link between financial and productive flows. Moreover, under the risk sharing principle required, Islamic financial institutions will share the profit or the loss incurred by the entrepreneur. There is an explicit sharing of risk by the financier and the borrower. This arrangement will thus entail the appropriate due diligence and the integrating of the risks associated with the real investment activity into the financial transaction. In this arrangement, the real activity is expected to generate sufficient wealth to compensate for the risks.

In contrast, conventional instruments generally separate such risks from the underlying assets. As a result, risk management and wealth creation may, at times, move in different or even opposite directions. Conventional financial instruments also allow for the commoditisation of risks. This has led to its proliferation through multiple layers of leveraging and disproportionate distribution, in turn, which could result in higher systemic risks, thus, increasing the potential for instability in the financial system.

In addition, transparency represents a basic tenet underlying all Islamic financial transactions. There is an inherent obligation on Islamic financial services providers to meet the appropriate standards of transparency. It is from the profit-sharing feature of Islamic financial transactions that imposes a high level of disclosure in the financial contract. The accountabilities of the respective parties involved in the transaction are clearly defined in the contract. This transparency also provides a strong incentive for Islamic financial institutions to appropriately manage risks. This disclosure allows the market to assign the appropriate risk premiums to the respective companies and thus the potential for the enhanced role of market discipline to take effect. These inherent features as required by the Shariah injunctions provides

inbuilt checks and balances which serves to ensure financial stability in the Islamic financial system.

These features are also reinforced by the development of a comprehensive regulatory and supervisory regime which has been strengthened considerably with the establishment of the Islamic Financial Services Board in 2002. It's establishment has also contributed to the harmonisation in the development of Islamic finance across different jurisdictions. Finally, education institutions have been established to develop the supply of professional talent and expertise in Islamic finance to support the growth and development of Islamic finance going forward.

The evolution of sophisticated Islamic financial products that have been structured based on multiple Islamic concepts have resulted in a new wave of innovation. These products have become competitive and efficient both in terms of product structure and pricing. The more recent innovations include the introduction of Islamic hedge funds and the creation of Islamic benchmark indices. There has also been increased listing of Islamic financial instruments in international exchanges. This has enhanced the depth of the Islamic financial markets has increased its attractiveness of an asset class for investment. This has contributed to increased sophistication of Islamic banking and takaful products evidenced by the recent surge of structured products and investment-linked products.

The sukuk market is fast emerging as the most significant form of Islamic financing and continues to receive strong interest as an avenue for fund raising and investment. The sukuk market has been gaining growth momentum, increasing at an average annual rate of 40 percent. Significantly, 90 percent of the sukuk issuance are corporate issuances. In Malaysia, the issuance of sukuk has surpassed the issuance of conventional bonds for three consecutive years, with the annual turnover in sukuk trading in the secondary market at about RM135 billion. Strong demand for sukuks have

also been spurred by the high levels of surplus savings and reserves in Asia and the Middle East.

The sukuk is also an attractive instrument to assist Islamic financial institutions in managing their liquidity requirements. At the same time, it is also an effective instrument used by corporations, institutions and sovereigns in tapping funds at competitive rates to finance long term funding needs. At this juncture, the demand for sukuk is tremendous. The high demand for the sukuk instrument is evidenced by the over subscription which has ranged from two to thirteen times. This has pushed down the cost of issuance by at least 10 to 20 basis points. This demand has originated from several different parts of the world, both from conventional as well as Islamic financial investors. Due to the scarcity of sukuk issuance, the investors have tended to hold the sukuk for investment thereby reducing the secondary activity in the market. Thus, has resulted in a higher pricing in the sukuk secondary market thereby generating good investment returns for investors. The sukuk thus offers a positive value proposition for both issuers and investors.

Let me turn to Malaysia's experience in Islamic finance. Malaysia has had three decades of experience in which we have developed a comprehensive Islamic financial system that operates in parallel to the conventional system. The supporting legal framework includes a dedicated legislation that takes into account the unique principles of Islamic contracts. The legal infrastructure also includes the court system and arbitration mechanism to resolve disputes to ensure that contracts relating to Islamic financial transactions are effectively enforced. The Islamic financial system is also well supported by a significant number of diverse players in the banking, takaful and capital market. Finally, for a dual financial system, the tax reforms have been undertaken to accord neutrality in treatment between conventional and Islamic financial products. The establishment of a national central Shariah Council has been important to ensure harmonisation of Shariah decisions in the Islamic financial services industry.

The Islamic financial industry in Malaysia has experienced rapid transformation in recent five years. The product range has now expanded into broad array of innovative instruments. Several new Islamic financial products were introduced which included residential mortgage backed securities, commodity based financing, as well as investment and equity linked product based on musyarakah, mudarabah and ijarah.

The Islamic financial system in Malaysia has evolved as a competitive component of the overall financial system, complementing the conventional financial system as a driver of economic growth and development. Malaysia continues to foster the expansion of the dual banking system where both, the Islamic and conventional systems operate in parallel to deliver innovative and competitive financial products and services. More recently, the increased pace of liberalisation in the Islamic financial services industry has increased foreign presence and participation in our domestic Islamic financial system. This has increase the diversity of players in our system. The Malaysian bond market has also been liberalised to enable foreign entities to raise ringgit and foreign denominated funds in our domestic market. Following these developments we are now entering a new phase in the development of Islamic financial system in Malaysia with the new initiatives to promote Malaysia as an International Islamic Financial Centre. This aims at strengthening our economic and financial inter-linkages and thus promoting greater trade and investment across borders. We are therefore entering a new phase of development for Islamic finance in Malaysia as it becomes more integrated with the international financial system.

Given the surge in demand for Islamic financial products and services, several countries and financial centres are increasingly participating in the industry. The global front-runners will be those with combined strengths of having the capabilities and resources, as well as the ability to secure the confidence of the international Islamic financial community. It is against this backdrop of rising competitive environment

that the potential of cumulative bilateral and multilateral strengths will become important in managing the complexities and constraints found in the Islamic financial services industry.

This increasing interest by several financial centres together with their international linkages will contribute towards creating a more integrated international Islamic financial system. Such centres, such as Hong Kong, have the potential infrastructure and the ability to facilitate product offerings that will bridge the regional and international financial linkages. Strategic alliances among Islamic finance players would be a catalyst unleashing the regional and global potential of Islamic finance.

In South East Asia alone there is an immense potential market to be tapped. This market not only comprises the 217 million Muslim population but extends to the non-Muslim community and the foreign national community that operates in the region. The region is increasingly becoming an investment destination, including from the Middle Eastern investors. In 2006, Asia Pacific region has surpassed Europe as second largest region for investment from Gulf Cooperation Council (GCC) with USD460 billion investment.

The recent specific initiative to enhance the securitisation market by Cagamas Berhad, the Malaysian Mortgage Corporation and Hong Kong Mortgage Corporation by establishing a joint venture company to provide a mortgage guarantee programme for both Islamic and conventional mortgages in Malaysia is an example of a collaboration. This could be a catalyst for more similar initiatives in the future.

Conventional financial institutions may also enter into alliances with Islamic financial institutions to be co-arrangers, to structure sukuk or other Islamic products based on Shariah compliant assets in this region. The wide ranging availability of such assets and the massive financing needs of the new growth areas in the region such as in China, Indonesia and Vietnam will be attracting funds from surplus economies such as from the Gulf economies. Efforts can also focus on facilitating

cross listing of sukuk in multiple jurisdictions. Additionally, the viability of setting up of Asian Sukuk Fund as an extension of Asian Bond Fund can also be explored.

Potential issuers may leverage on Malaysia's sukuk platform and the strengths as the world's largest sukuk issuance centre with over **US\$56b** or **62%** of world's sukuk issues. Malaysia has one of the most active primary sukuk market with an average annual growth of 17% during the period 2001-2006. It also has one of the most active secondary market with the turnover of the sukuk trading registered more than USD40 billion annually. International issuers with good rating will benefit from the simplified issuance procedures. This is in addition to the ability to issue multi-currency sukuk and the flexibility to swap RM funding into other currencies to enable foreign issuers to capitalize on the price premium of issuing RM denominated sukuks.

A further area of collaboration is outsourcing, in-sourcing or white labelling. These mechanisms will not only serve as a means to drive down cost of doing business, achieving economies of scale and the avoidance of duplication of resources, but also gives optimum focus by players to develop the newly ventured Islamic finance business. Malaysia's experience in Islamic financial operations and product design can be leveraged upon to systematically structure a complete solution to be offered to other players.

Going forward, Islamic finance as a new industry requires more initiatives to expand the horizon of business parameters and innovative products offerings. There is a need to conduct further in-depth research on Shariah issues relating to risk mitigation, liquidity management and hedging. The combined market knowledge and insights from education and training institutions such as INCEIF, the International Centre for Education in Islamic Finance in Malaysia can make meaningful contributions to the global Islamic finance industry that addressed both market needs and Shariah compliance. In addition, INCEIF's flagship

programme, the Chartered Islamic Finance Professional (CIFP) offers the world's first professional certification programme in Islamic finance aims to nurture skilled talent pool for Islamic finance.

Let me conclude my remarks. The global Islamic finance industry has evolved from a faith-based to a business driven industry for all communities. With total global Islamic financial assets amounting to only 40% of the largest conventional bank and with only 300 players compared to 23,000 conventional players

globally, competitive pressure moving forward are likely to be intense. But with the underlying strength inherent in Islamic finance and its potential role in bringing together different parts of the world with surplus funds in search of investment opportunities to those with financing requirements accords tremendous opportunities to be drawn from Islamic finance. The combined efforts and collaborative alliances will pave the way for mutually reinforcing developments that will contribute to the overall international finance system and global economic prosperity.

The Launch of Labuan International Business and Financial Centre Kuala Lumpur, 28 January 2008

Launch Address by

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

It is with great pleasure that I welcome you to the launch of Labuan International Business and Financial Centre. This decade has seen the Labuan Offshore Financial Centre demonstrate its ability to adjust and reinvent itself in a rapidly changing international and regional environment. This decade has also witnessed the robustness and resilience of the Labuan Offshore Financial Centre as evidenced by its ability to continue to expand and mature even during the most challenging of periods.

The global and regional market place however, continues to transform, bringing with it new opportunities and challenges. To have the flexibility to benefit from the new opportunities and to have the capacity to rise to the new emerging demands and challenges, continued reassessments need to take place to rediscover new directions, build new strengths, new comparative advantages and to define our new role in this ever changing and more competitive market place. Today we are defining a new beginning for the Labuan Offshore Financial Centre as it positions itself for a much larger role. Your presence here today to share in this auspicious occasion is indeed appreciated.

In providing the full range of financial services, Labuan offers a total financial solution both in both conventional and Islamic finance. Labuan also has the top-ranked financial institutions that originate from more than 80 countries, including Islamic financial institutions that also originate from different parts of the world. The Labuan Offshore Financial Centre has seen steady expansion both in terms of the number of players, the diverse financial product offering and the volume of activity.

Labuan today has also become a thriving regional business centre. It is making its mark as a regional base for the oil and gas industry and as an entreport for the regional triangle of Brunei-Sabah-Philippines. Its convenient location and excellent deep harbour are natural advantages. Its modern airport which has been enhanced has also promoted increased tourism. Being a duty free zone and a free port status has supported these activities. Growth in these peripheral commercial and economic activity in Labuan has provided the potential for Labuan to succeed as an international business and financial centre.

Labuan benefits from being centrally located in the Asia Pacific region, a region that has been one of the fastest growing regions in the world. The Asian region is also among the most open in the world in terms of international trade and investment. A more recent phenomenon is the increased intra-regional trade and investment resulting in greater regional economic integration. This has been reinforced further by increased investment flows from the Middle East to Asia. In 2006, the Asia Pacific surpassed Europe as the second largest region for investment from the Gulf Cooperation Council (GCC) with USD460 billion investment.

Despite the current financial upheavals that are occurring in the international financial system, the underlying trends in the region including the cumulative regional demand, greater regional integration and the increased appeal of the region as an investment destination have continued to present immense opportunities for Labuan as a business and financial centre.

Labuan is well positioned to tap these business opportunities. Key to the success of a business and financial centre is its competitiveness, the convenience and cost effectiveness of doing its business, its connectivity and the confidence in the centre. The Government of Malaysia has been highly committed to ensuring that Labuan has all these elements. Massive investment has been made to provide for the physical infrastructure and amenities in Labuan. This includes the modern communication links, and the business and education amenities to support Labuan's designated role as an international business and financial centre. Recently, the Labuan International airport was enhanced further and open sky policy has been adopted to facilitate enhanced access to the island. Also, improvements have been made to the deep harbour facilities.

Increased access is however, not only limited to the physical access but also the easy access to other financial markets. This requires the infrastructure that allows for the efficient conduct of international financial transactions. Intermediaries need to be able to have easy access to participate in other jurisdictions. To facilitate this and to promote the cost competitiveness in Labuan, it is supported by a balanced regulatory regime that effectively regulates the market while facilitating market development. LOFSA, the Labuan Offshore Financial Services Authority was established ten years ago not only to put in place an effective regulatory regime and to provide the supervisory oversight, but also to focus on market development and facilitation. To further ensure a conducive business environment, it is also supported by a robust legal framework including trust laws. While Labuan has in place a business friendly tax regime it also has never been positioned as a low tax finance repository. On the contrary it has leveraged on its strengths and unique advantages to meet the market's need.

In going forward, a number of programs will be initiated. The Labuan International Business and Financial Centre (IBFC) aspires to achieve the status of being the "gold standard for

holding company jurisdiction". This market has been identified as a further business driver for Labuan IBFC. Malaysia's extensive tax treaty network with over 63 countries in addition to the introduction of a more flexible tax framework supports this initiative. It was announced in the 2008 Budget that Registered Labuan offshore companies now have the option to be taxed under the Malaysian Income Tax Act 1967 or the Labuan Offshore Business Activity Tax Act (LOBATA) 1990, thus enabling businesses to structure their transactions more efficiently. The Labuan IBFC's competitiveness will be further enhanced through a revision of the pricing structure pertaining to incorporation and maintenance fee charges. There will be an annual reviews and prices will be revised in response to competitive market developments.

The Labuan IBFC will also leverage on the national strategy of the Malaysian Islamic Financial Centre by promoting Syariah-compliant trusts and foundation. These products will complement Islamic financial products and services already available in Kuala Lumpur. Efforts will also be taken to further develop Labuan's captive insurance business which has enjoyed commendable growth over the years.

Conclusion

The establishment of Labuan as an international offshore financial centre in 1990 was indeed a bold step in its time. We are now seeing the payoffs from this initiative. With the transformation of Labuan as an International Business and Financial Centre, our ambition will be taken further. The new name signals that Labuan is ready to take on the much broader and larger role. The new name also represents a commitment. A commitment for the future. To demonstrate this commitment, the Government and the regulators have put in place the supportive and enabling environment to promote a more connected and more cost effective environment. Continued initiatives will also be taken to remove any impediments and obstacles to a more efficient delivery system and to advance forward the Labuan IBFC.

The responsibility for ensuring the ambitions of the Labuan IBFC to be realised, is however, a shared responsibility. The future will be for the competitive. The future will be for the cost efficient. The future will be for the creative and innovative. The future will be for those that

are able to give good value propositions to their customers. Achieving this will therefore involve the industry, the market professionals and participants. With these cumulative efforts, we are confident Labuan IBFC will be another chapter of success, Insya Allah.

Nikkei Islamic Finance Symposium 2008
“Islamic Finance: Constant Evolution and Emerging Opportunities”
Tokyo, 23 February 2008

by

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

It is my great honour and pleasure to be here in Tokyo to speak at this Islamic Finance Symposium organised by the NIKKEI. This is an important forum that provides the opportunity to foster a greater understanding and appreciation of Islamic finance and its increasing role in the international financial system. We are also very honoured by the presence and participation of Governor Fukui from the Bank of Japan at this Symposium.

My remarks today will focus on the evolution and new emerging opportunities in Islamic finance as its growth and development in the global financial system gains further momentum. My presentation will also touch on our experience in the development of an Islamic financial system in Malaysia which operates side by side with the conventional financial system and in which the international dimension has now become increasingly significant.

Evolution of Islamic Finance

Modern Islamic finance was initially developed as an intermediation channel for Muslims to conduct their savings and investment activities in accordance with the Islamic principles. As recent as five years ago, however, Islamic finance has experienced major transformations. Its rapid evolution is particularly evident in five dimensions of its development.

Firstly, from being concentrated in Muslim populated regions, Islamic finance is now viewed as a **competitive form of financial intermediation** that has drawn significant participation by non-Muslims. For borrowers, it is seen as an alternative means of financing. For investors, it is seen as a new asset class. Islamic finance has thus witnessed exceptional

growth, not only in the Muslim world, where its growth is premised on religious and business considerations, but also across the Western world where the growth is driven by commercial and business considerations. Today, the total assets of the Islamic financial system has surpassed one trillion US dollars, about fivefold of its magnitude five years ago. Islamic finance is now among the fastest growing financial segments in the world with an estimated annual growth of 20 percent.

Secondly, the nature of the business of Islamic finance has also evolved, from being mainly focused on retail and trade financing to the financing of other commercial business activities. With the emergence of more diverse Islamic financial institutions and the development of the Islamic financial markets, the **scope of Islamic finance business has been expanded** to include private equity, project finance, the origination and issuance of sukuk, and fund, asset and wealth management activities. The pace of product innovation has also intensified with more sophisticated Islamic banking and takaful products as evidenced by the surge of structured products and investment-linked products. These products have become competitive both in terms of product structure and pricing. The enhanced depth of the Islamic financial markets has also increased its attractiveness as an asset class for investment. These developments have resulted in an extensive range of Islamic financial products and services that is being offered to consumers and businesses.

The third dimension in which there has been significant evolution is in the **regulatory and legal framework** for Islamic finance which has taken into account the distinct features of

Islamic financial transactions. This has ensured that the growth and developments of Islamic finance is accompanied by the corresponding development of the supporting legal, regulatory and supervisory framework to ensure its soundness and stability. The establishment of the Islamic Financial Services Board in 2002 also marked an important milestone in the development of the prudential regulatory standards and best practices for Islamic financial institutions. Its establishment has also contributed to the harmonisation in the development of Islamic finance across different jurisdictions.

Fourthly, the international dimension of Islamic finance has rapidly gained significance as it evolves to become an **increasingly important part of the international financial system**, and as it becomes poised to contribute towards greater global financial integration. Islamic financial institutions have now ventured beyond their domestic borders and funds raised in Islamic financial markets in different jurisdictions have drawn investors from financial centres across the globe. As market players across continents participate in the expansion of inter-regional investment flows, it has enhanced financial linkages among the major regions. To date, the number of Islamic financial institutions worldwide has increased to more than 300, spanning more than 75 countries both in the Muslim and non-Muslim countries¹. The expansion of the inter-linkages among intermediaries and markets across regions would contribute towards a more efficient allocation of financial resources across borders and thus contribute to enhancing global growth prospects.

The fifth dimension that has seen significant change is in the **development of human capital in Islamic finance**. It has been a vital development that has been key in ensuring an adequate supply of talent and expertise for further expansion and development of the Islamic financial services industry. High caliber professionals that have the combined knowledge and understanding of the Shariah

with the necessary skills in finance² are now in great demand. Recognising this, several major institutions of higher learning are offering more focussed and structured programmes in Islamic finance. The establishment of the International Centre for Education in Islamic Finance (INCEIF) in Malaysia in 2006 represents a structured investment in human capital development to support the global development of Islamic financial services industry. It is envisioned that INCEIF will act as a professional certification body as well as an education centre for specialised post-graduate programmes in Islamic finance.

Distinctive Features of Islamic Finance

While Islamic finance has continued to evolve, the distinct features remain fundamental. Islamic finance is required to operate in accordance with the rules of Shariah from which it derives its unique characteristics. The Shariah injunctions require that the Islamic financial transaction be supported by an underlying economic activity. This requires that the financial transaction must be accompanied by a genuine trade and business related activity.

Based on this arrangement, interest-based transactions are prohibited. Islam encourages business and trade activities that generate a fair and legitimate profit. In Islamic finance, there is therefore always a close link between the financial and productive flows. This intrinsic principle contributes towards insulating the Islamic financial system from potential risks of financial stress resulting from excess leverage and speculative financial activities.

A further fundamental principle of Islamic finance is the risk and profit sharing feature of Islamic financial transactions. This could involve an arrangement whereby the Islamic financial institution shares profit with the investor in a Mudarabah contract or in a Musyarakah contract, both parties share in the profit or loss. These arrangements involve an explicit sharing of the risks by the Islamic financial institution and the investor, thus requiring the Islamic

¹ Sources: Islamic Finance News, Islamic Financial Services Board & National Authorities.

² The trend is now to have both "Shariah savvy financial practitioner" and "financial savvy Shariah Scholars".

financial institution to appropriately manage the risks associated with the transaction. It entails the appropriate due diligence and the integrating of the risks associated with the investment activity into the financial transaction. The real activity is thus expected to generate sufficient wealth to compensate for the risks.

It is from this profit and risk sharing feature of Islamic financial transactions that a high level of disclosure and transparency is required. This represents a basic tenet underlying all Islamic financial transactions. There is an inherent obligation to meet the appropriate standards of transparency. The accountabilities of the respective parties involved in the transaction are also clearly defined in the contract. These disclosures also allow the market to assign the appropriate risk premiums to the respective companies thereby enhancing the potential for market discipline to take effect. These intrinsic features as required by the Shariah injunctions provide an in-built checks and balances which serve to ensure financial stability in the Islamic financial system.

Malaysian Experience

Allow me to take this opportunity to share with you Malaysia's experience in developing the Islamic financial system, and in particular, the Islamic capital market. Malaysia has developed over more than two decades, a comprehensive Islamic financial system that operates in parallel with the conventional financial system. The Islamic financial system in Malaysia has evolved as a competitive component of the domestic financial system with a significant number of diverse players in the Islamic banking, the takaful industry and the Islamic money and capital markets. Our approach has been to focus on institutional development, reinforced by a robust Shariah, legal and regulatory framework as well as the investment in human capital development. In this more recent decade, attention has been focussed on developing the financial markets, in particular the sukuk market, and on the liberalisation of the Islamic financial system.

We are now entering a new phase in the development of Islamic financial system in Malaysia with initiatives to position Malaysia as International Islamic financial hub. The initiative is aimed at strengthening our international economic and financial inter-linkages and thus promoting greater regional and international trade and investment activities. As part of the wide ranging liberalisation measures, we have seen the entrance of new foreign Islamic financial groups into our financial system. New licences have been issued and greater foreign interest in the domestic Islamic financial institutions have also been permitted. In addition, the listing rules were liberalised to facilitate foreign and cross-border listings. New licences are also being issued for International Islamic Bank and International Takaful Operator to conduct Islamic banking and takaful and retakaful business in international currencies.

The most significant progress that has been achieved is in the development of the Malaysian sukuk or Islamic bond market. The Malaysian sukuk market is now the largest Islamic bond market in the world with more than 62% (or USD60 billion) of the global outstanding sukuk having been originated from Malaysia. Supported by a comprehensive infrastructure including the settlement and bond information system, Malaysia has an active primary sukuk market with an average annual growth of 17% over the period 2001-2006. It also has one of the most active secondary markets with a turnover of sukuk trading registering of more than USD40 billion annually.

The Malaysian bond market has also been liberalised to enable foreign entities to raise ringgit and foreign currency denominated funds from our market. International issuers may thus issue multi-currency Sukuks or alternatively have the flexibility to swap domestic currency funding into other currencies. At this juncture, I'm also pleased to inform you that a Malaysian corporation recently issued the largest-ever sukuk issue in the world amounting to equivalent USD4.7 billion which was two times oversubscribed. This hybrid sukuk which has

both equity and debt natures is one of the several innovative instruments that has been issued in the sukuk market.

Malaysia's development of Islamic finance has contributed positively to our overall financial system in several respects. This has resulted to a more diversified financial system that has increased its overall resilience. Secondly, it has increased our international linkages. Thirdly, it has also contributed to greater financial inclusion particularly in the area of financing for small and medium scale enterprises and micro financing. Then, enhanced with the in-built checks and balances, it contributes towards financial stability. Finally, Islamic finance has become a new area of growth that has become very vibrant in generating income, wealth and employment.

Opportunities in Sukuk

In the current liberalised and globalised environment, Islamic finance is now at the threshold of a new dimension in strengthening financial **inter-linkages** between nations in the global economy. With the expanded scope of activities in Islamic finance, the Islamic bond market or Sukuk market has fast become an important avenue for **fund raising and investment activities**. The Sukuk market has registered a remarkable growth, increasing at an average annual rate of 40 percent with a current size of more than USD82 billion. The **vast potential** in Sukuk market in the international financial system indeed represents the crest of a new wave of innovation in Islamic finance. This is evidenced by the active participation of a great number of global players such as investment banks, Islamic banks and securities firms in the issuance of Sukuk.

The Sukuk market brings with it great benefits to both issuer and investors. For issuers that include government agencies, multinational

corporations and multinational development institutions, Sukuk plays a multi-faceted role in meeting different funding requirements ranging from large infrastructure and developmental projects to capital and business expansion. This is particularly important for emerging market economies. The Middle East and Asia currently represent the two fastest growing regions in the global economy. These regions are aggressive in their privatisation efforts and in the implementation of infrastructure and developmental projects. Asia alone will be spending an estimated USD1 trillion on infrastructure over the next five years, while infrastructure requirements in the Middle East are estimated to be USD700 billion over the same period³. While in Malaysia, the National Economic Regional Corridor plan requires an estimated USD192 billion (RM620 billion) of investment⁴.

On the demand side, the issuer also benefits from **the competitively attractive pricing** of Sukuk ranging from 10 to 20 basis points lower than mainstream bonds. This has resulted from the continuous over subscription of the sukuk which has ranged from two to thirteen times. The phenomenal demand for sukuk is further reinforced by excess liquidity in the global financial system. This demand comes from a **relatively wider investor base** that comprises both the conventional and Islamic investors. The strong demand for sukuk has also been spurred by the higher level of surplus savings and reserves in Asia. In the case of Japan, apart from the high savings rate, Japan has the largest percentage of high net worth individuals wealth distribution in the Asia Pacific.

From the investors' perspective, besides the intrinsic value of sukuk which is largely **asset-backed**, convertible to shares and exchangeable with shares, there are **benefits of diversification**. Sukuk is fast becoming a **new asset class**. Sukuk has also generated

³ Source: GCC Research, Kuwait Finance House.

⁴ An estimate amount of investments for Eastern Corridor Economic Region (RM112 billion), Northern Corridor Economic Region (RM100 billion), Iskandar Regional Development (RM382 billion) and Sabah Development Corridor (RM25.8 billion).

good investment returns for investors arising from its higher pricing in the secondary market due to the “buy and hold” preference and its scarcity.

Opportunities in Takaful

The other opportunities in Islamic finance are in the takaful or Islamic insurance and re-takaful. The global takaful market, in particular, has also undergone positive developments at the international level. From only a single takaful company being in existence more than twenty years ago in Sudan, the takaful industry has now expanded with the establishment of more than 50 takaful companies worldwide with a total contribution estimated at about USD3 billion for the year 2005. The takaful industry is expected to grow at about 20% per annum to reach USD7.4 billion in global annual contributions over the next ten years⁵. It is also encouraging to note that the number of retakaful companies have also grown in tandem with the increased number of takaful companies⁶. The need for **strong and credible retakaful operators** globally is important to complement the growth and expansion of the takaful industry.

Let me turn to Japan’s potential participation in Islamic finance. We welcome the participation of Japanese financial institutions, authorities and corporations in Islamic finance, particularly, in the Islamic capital markets. Japan thus far has for several decades had a significant economic role in the Asian region in terms of trade and investment. Japan’s investment in the region is estimated to be USD45 billion over the period of 2004-2006⁷. Japan has also been consistently ranked among the top five investing nations in Malaysia, with investment flows amounting to 25.7% of the total flows for the period of 2000

to 2006. In 2006 alone, Japan foreign direct investment inflow into Malaysia was at USD6.1 billion⁸. Japan has also remained a significant partner in trade with Malaysia.

While Japan’s economic relationship in investment and trade in the region is well established, there is a significant potential for strengthening further the financial linkages in future. There is potential to evolve the direct investment and trade in goods to grow the financial ties. Islamic finance represents a vehicle that could further deepen our financial relationship and the regional financial integration process. By enhancing new linkages in this relationship and the prospect for greater integration, it would contribute towards unlocking potential opportunities for mutual prosperity of the region.

To advance relations in the area of Islamic finance, a memorandum of understanding between the Central Bank of Malaysia and Japan Bank for International Corporation (JBIC) was signed in 2007. There is also a strategic alliance between one of the world largest Japanese insurance groups with a domestic insurance company in Malaysia which resulted in the establishment of a takaful company. Efforts can also be focussed on facilitating cross listing of sukuk in multiple jurisdictions. Japan may also use Malaysia as a platform for innovation and research in Islamic finance. There are various institutions, including the industry-owned research and training institute in Islamic finance, the Islamic Banking and Finance Institute Malaysia (IBFIM), INCEIF and universities which have undertaken research on Islamic finance. Thus, it is hoped that the Japanese participation in the Islamic financial markets would contribute towards further international financial integration and thus achieve a more efficient allocation of resources across borders.

⁵ Based on projection by Institute of Islamic Finance and Insurance & Investor Offshore Review, February 2006.

⁶ To-date there is more than 10 retakaful companies providing retakaful capacity for both family and general takaful business.

⁷ United Nations Conference on Trade & Development’s (UNCTAD) World Investment Report 2007.

⁸ Sources: JETRO from Ministry of Finance Balance of Payments Statistics and Bank of Japan foreign exchange rates.

Conclusion

Let me conclude my remarks. The increasing awareness and appreciation of the inherent strengths of Islamic finance and its tremendous potential for advancement have ignited interests amongst the global financial community to venture into this new sphere of

finance. Taking advantage of the increasing role of Islamic finance in bringing together different parts of the world with surplus funds in search of investment opportunities, with those that have financing needs, will increase these mutually reinforcing prospects. We look forward to Japan's participation in this new financial evolution.

9th Bank Human Resources Conference 2008
Organised by the Indian Institute of Banking and Finance
“Building Human Capital for Emerging Challenges”
Kuala Lumpur, 29 February 2008

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 9th Bank Human Resource Conference organised by the Indian Institute of Banking and Finance (IIBF). It is our honour to host this conference that is being held outside India for the first time. This is one of the concrete outcomes of the alliance that has been entered into between the Indian Institute of Banking and Finance and the International Centre for Leadership in Finance following the MoU that was signed about three months ago between the two organisations.

The development of human capital has to be a constant undertaking in an environment of constant change. As recent as ten years ago, we have seen the economic and financial environment dramatically transformed. There has therefore required a corresponding change in the knowledge, skills, competencies and capabilities that are now required, in particular, by the banking industry, which is a highly knowledge-intensive and skills based industry.

New challenges have also emerged in this environment arising from the rapid globalisation and internationalisation of the financial system and the significant advancement in technology. These developments have led to a rapid pace of innovation and enhanced international interdependence and inter-linkages. This has generated an environment that is increasingly more complex, competitive, uncertain and ambiguous. The recent episodes of financial turmoil, have shown that even financial systems in developed and advanced economies continue to be vulnerable to financial stress.

This more difficult operating environment demands new skills and the ability to manage

these new challenges. Indeed, the role of leadership has changed. It is essential to have the talent that are not only able to see the new emerging opportunities, but also to be able to deal with the high level of unpredictability and navigate through turbulent conditions. The industry leaders need to be visionary and comprehend future trends, chart strategic directions and adapt to changes to stay competitive and relevant. Effective leaders in this era, will be those who are continuous learners, who are on the cutting edge of excellence, who have strong convictions, and yet, having humility to recognise the need to reinvent themselves and inspire their organization to adapt to the new environment. Such attributes are vital if the financial services sector is to forge ahead and remain at the forefront of new innovations and thus secure long-term competitiveness. In this process, there needs to be avenues for continuous learning. The establishment of ICLIF is part of our commitment towards providing such an avenue to enhance leadership capability and develop world-class leaders in the financial services sector.

The changing configuration of the global economy and financial markets, increasing regional economic and financial integration, increasing internationalisation of financial services, the continued enhancement to the regulatory structures and approaches will have a significant bearing on the future of the financial services industry. The road in front of us is therefore likely to be significantly different to the one from which we have travelled on. The investment in human capital development is thus important for the future development and growth in the financial services sector.

Building human capital has become much emphasised in today's world. Successful banking institutions in the future will be increasingly dependent on intangible assets such as talent. As competition intensifies, the need for banking institutions to attract and retain the best skills and talents will become more urgent. Going forward, the availability of talents will become the pivotal factor determining the capacity for the industry to reinvent and transform. Banking institutions would need professionals with the requisite skills and expertise not only at the strategic and management level, but also at the technical and operational level. Successful institutions will be the ones which accord high priority to the continuous enhancement of human capital. Human capital development has thus become of strategic importance and is integral to the success of an organisation. The involvement by senior executives in the management of human capital development has also become essential. Senior executives need to take the lead and devote a considerable amount of their time to this initiative. Human resource development functions is integral to the talent management process and in supporting the human capital management strategy. Of equal importance is that this should occur at all levels in the organisation. In essence, the accountability for talent development requires concerted efforts throughout the organisation and needs to be embedded as part of the working culture that is communicated, shared and understood at all levels.

While the need for human capital development is apparent, what is less apparent are the appropriate methods and policies that should be adopted to advance human capital development. The financial services industry needs to identify the appropriate strategic direction for human capital development. Attention need to be given to the entry level, to the specialists and to the senior management levels. This would benefit from greater industry-university linkages which is a major channel through which the talent requirement and talent gap can be narrowed. The industry involvement in the curriculum design and delivery will ensure graduates are equipped with the relevant knowledge and skills that meet the requirements of the industry. Participation

by the industry players may be in the reform of the academic curriculum and methodologies and in providing other forms of practical support to the institutions of higher learning. This will contribute directly towards meeting the human capital needs for the future.

The quality of human capital is the cutting edge of competitiveness. Having competent staff to deliver high quality products and services is critical to building customer confidence and goodwill, driving customer satisfaction, enhancing reputation and ultimately realising individual institutions' corporate vision and strategic goals. It is therefore, in the best interest of banking institutions to strengthen further the competence and professionalism of staff in the industry. In this regard, financial institutions can of course adopt the measure of "buying talent" from the market. This may however, risk in high compensations that are not commensurate with the value added. The more desirable option is the building, developing and maintaining a pipeline of talent from within the company.

Let me turn to Malaysia's experience in human capital development for the financial services industry. In Malaysia, structured and comprehensive approach to human capital development has been a key part of our efforts for the development and advancement of the industry. The programmes by ICLIF, which is now in its 6th year of operations, provide programmes in leadership development for the senior management level in the financial services industry. The programmes carried out by the Institute of Bankers Malaysia, the training arm of the banking industry, have also been recently reviewed to meet the new demands of the financial sector. In addition, dialogue between the industry and other education providers including institutions of higher learning have taken place to promote well equipped supply of talent. In September 2007, Bank Negara Malaysia initiated the Financial Sector Talent Enrichment Programme (FSTEP) to train and prepare 1000 highly qualified graduates for immediate placements in banking and insurance institutions. This effort is undertaken in collaboration with the industry and training institutes and is aimed at boosting the supply

of well-trained and competent personnel for the financial services industry.

In the area of Islamic finance the continued international expansion has increased the demand for talent and expertise in the industry. The establishment of the International Centre for Education in Islamic Finance (INCEIF) in Malaysia in 2006 represents a structured investment in the development of human capital to support this global development of the Islamic financial services industry. The programmes are for practitioners and graduate students. In addition, it is envisioned that INCEIF will act both as a professional certification body as well as an education centre for post-graduate programmes in Islamic finance.

With the firm commitment to build human capital, the challenge is to formulate the

appropriate strategies and mobilise the resources necessary to produce results that will enhance the intellectual capital of the industry. This will require the combined efforts of internal strategies within banking institutions, that involves a holistic approach that coordinates the strategies for human resource management and development reinforced by strategies for organisational development. This will also involve putting in place the appropriate processes and structures. A total solution will be required. These efforts will also need to be supported by education providers. Finally, this initiative of bilateral engagement on the issues in developing talent in the industry will also gain from the synergy and will contribute to strengthening the ability to further the agenda of building human capital in the financial services industry.

CALENDAR OF EVENTS January-March 2008

15 January 2008

At the Seminar on Islamic Finance in Hong Kong, Governor Dr. Zeti delivered her keynote address on "Towards Gaining Global Growth Potential of Islamic Finance". Governor highlighted that strategic alliances among Islamic finance players will help realise the global potential of the industry in the wake of increasing interest in Islamic finance by several financial centres, including Hong Kong. She added this will lead to a more integrated international Islamic financial system and tap the immense markets of both Muslim and non-Muslim communities. Governor said that conventional financial institutions can also work together with Islamic financial institutions to raise sukuk or Islamic bonds or structure other Islamic products which are Shariah-compliant. Governor indicated that the setting up of an Asian Sukuk Fund could be explored as an extension of the Asian Bond Fund.

28 January 2008

The Labuan International Business and Financial Centre (Labuan IBFC) rebranded itself and a new identity was launched to generate greater awareness, giving the centre a much broader role, expanding beyond financial services to include international business. IBFC will also step up its efforts to attract more players, including multinationals and to this end, by improving its competitiveness, particularly in the areas of tax structures and legislation. Labuan IBFC was formerly known as the Labuan International Offshore Financial Centre.

29 January 2008

At its first meeting for 2008, the Bank's Monetary Policy Committee (MPC) decided to leave the Overnight Policy Rate (OPR) unchanged at 3.50%. The MPC stated that the Malaysian economy had performed well in 2007 and continues to maintain a steady growth momentum. It added that the future thrust of monetary policy would depend on new information and assessment of the change in the balance of risks to the medium term outlook for inflation and growth. At its subsequent meeting on 25 February, the MPC maintained the OPR at 3.50% saying that the assessment of the balance of risks to growth and inflation did not prompt a change in the monetary policy stance.

The Bank, on the same day, also announced the successful roll-out of the Financial Sector Talent Enrichment Programme (FSTEP). The FSTEP initiative, a pioneering programme developed by the Bank in close collaboration with the financial services industry, is aimed at supporting the human capital needs of the Malaysian financial services industry. The first batch comprised 297 candidates selected out of about 2,900 applicants. Participants who successfully complete the financial services training programme will be absorbed to work in the financial sector.

4 February 2008

The Bank signed a Memorandum of Understanding (MoU) with Brunei Darussalam Ministry of Finance at Bandar Seri Begawan on information exchange and capacity building to combat money laundering and terrorism financing. The signing of the MoU is in line with the Bank's thrust of forging alliances and collaboration with foreign institutions to fight money laundering and terrorism financing.

12 February 2008

The Bank announced the issuance of *Bon Simpanan Merdeka 2008* amounting to RM2 billion on 1 April 2008. The Shariah principles based scrippless bond, which offers a tax-free return of 5% per annum, is an additional savings instrument made available for Malaysian senior citizens aged 55 years old and above who are not employed on a full-time basis.

23 February 2008

In her keynote address at the Nikkei Islamic Finance Symposium in Tokyo, Governor Dr. Zeti spoke about the evolution and the emerging opportunities of Islamic finance to the global financial community and Malaysia's experience in the development of Islamic finance system. Governor highlighted on how the development of Islamic finance in Malaysia has resulted in a more diversified financial system that has increased its overall resilience. She noted that Islamic finance, with the in-built checks and balances, can contribute towards financial stability and has become a new area of growth that is very vibrant in generating income, wealth and employment. Governor also highlighted the ample benefits of fostering further collaboration between Malaysia and Japan in the area of Islamic finance as well as significant opportunities for Japanese corporations, issuers and investors in the area of Islamic finance in Sukuk and Takaful business.

26 March 2008

The Bank released the 2007 Annual Report and the 2007 Financial Stability and Payment Systems Report. Governor announced that in 2007, growth in the Malaysian economy strengthened despite a weaker external environment. Robust domestic demand, driven by strong private consumption and investment activities, raised real GDP growth to 6.3%. This was reinforced by increased public sector spending. Governor added that growth was broad-based, reflecting expansion across all sectors in the economy, led by the services sector. Governor highlighted that the financial system remained resilient and well capitalised throughout 2007 despite challenging external conditions marked by a slowing US economy, rising global inflationary pressures and more volatile financial markets.

In 2008, the Malaysian economy is expected to remain favourable due to the country's strong fundamentals with GDP projected to expand by 5-6% led by domestic demand. Inflation is expected to be in the range of 2.5 to 3.0%, with risks remaining on the upside emanating from external price pressures. On the financial system, Governor added that the focus in 2008 will be on effective surveillance, institutional development and financial market infrastructure development.

The Bank, on the same day, also announced the establishment of International Shariah Research Academy for Islamic Finance (ISRA). The establishment of ISRA will promote applied research in the area of Shariah and Islamic finance as well as being a repository of knowledge for Shariah views and undertake studies on contemporary issues in Islamic financial industry. ISRA will contribute towards strengthening human capital development in the areas of Shariah and provide platform for greater engagement amongst practitioners, scholars, regulators, academicians via research and dialogues, both in the domestic and international environment. It is envisioned that with greater research and dialogues, mutual respect and recognition would emerge within Islamic financial industry global community.