

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

OVERVIEW

Sustained growth momentum in the Malaysian economy

The Malaysian economy registered a growth of 6.3% (1Q 08: 7.1%) in the second quarter of 2008. Growth was supported by strong external demand while domestic demand expanded at a more moderate pace.



Growth in domestic demand moderated but remained strong at 7.8% in the second quarter (1Q 08: 10%). Private consumption increased by 9% (1Q 08: 11.7%) in an environment of higher consumer prices and softer consumer sentiment. Higher expenditure on emoluments, defence, supplies and services supported the growth in public spending (7.1%; 1Q 08: 10.5%). Investment activity was sustained at 5.6% (1Q 08: 6%), supported by continued inflow of foreign direct investment, mainly into the services and manufacturing sectors, and higher development expenditure by the Government. While most investment indicators suggest continued expansion in capital spending, the higher cost of investment activities dampened investment spending in real terms.

All key sectors contributed positively to growth, except for mining. The services sector expanded by 7.6% (1Q 08: 7.9%), led by strong growth in the wholesale and retail trade, and favourable performance in the communication, transport and storage; and finance and insurance sub-sectors.

The manufacturing sector registered a 5.6% growth (1Q 08: 7%), led by domestic-oriented industries, particularly transport equipment, food and construction-related industries. Export-oriented industries grew at a more moderate rate due mainly to lower output in the computers and parts and decline in production of petroleum and chemical industries. Growth in the overall electronics and electrical (E&E) sector was sustained by external demand for electrical products and semiconductors. Meanwhile, selected resource-based industries such as off-estate processing and rubber products continued to lend support to export-oriented industries.

Growth in the agriculture sector (5.9%; 1Q 08: 6.3%) was underpinned by double-digit expansion in crude palm oil production. The construction sector grew at a moderate pace (3.9%; 1Q 08: 5.3%) amidst the rising cost of building materials. Meanwhile, the mining sector contracted slightly due to lower output of natural gas.

The headline inflation rate, as measured by the change in the Consumer Price Index (CPI), rose to 4.8% in the second quarter (1Q 08: 2.6%). The higher inflation during the quarter reflected the higher retail prices for petrol and diesel following the subsidy restructuring on 4 June 2008, as well as higher food prices. Fuel and food prices rose on account of higher global prices for commodities and energy. Headline inflation is expected to remain at elevated levels from June 2008, before beginning to moderate towards the middle of 2009.

On the external front, the trade balance registered a record surplus of RM40.8 billion (1Q 08: RM26.8 billion) in the second quarter supported by strong commodities and resource-based manufacturing exports. Gross exports grew strongly by 20.8%, due mainly to continued strong growth in agriculture and mineral exports, benefiting mainly from higher commodity prices. At the same time, manufacturing exports were higher (+12.3%; 1Q 08: -1.9%), underpinned by higher prices in resource-based products and semiconductors.

Gross imports increased by 9.8% in the second quarter, reflecting stronger growth in all categories of imports. Intermediate imports increased by 10.2%, in line with higher manufactured exports. Continued investment activities led to higher demand for capital imports. Strong growth of 21.1% in consumption imports reflected mainly continued consumption activities and high prices for processed food and beverages.

In the financial account, gross inflows of foreign direct investment, as captured by Bank Negara Malaysia's Cash BOP System, increased to RM12.2 billion (1Q 08: RM7.1 billion). The FDI inflows were mainly directed into the services, manufacturing, and oil and gas sectors. After adjustment for gross outflows due mainly to repayments of short-term loans, net FDI increased to RM8.3 billion (1Q 08: RM2 billion). Overseas investment by Malaysian companies recorded a net outflow of RM3.5 billion (1Q 08: -RM6.6 billion) reflecting sustained investments in the manufacturing and services sectors. Meanwhile, portfolio investment registered a net outflow of RM31.8 billion (1Q 08: +RM1.5 billion) due to net liquidation of both bonds and equities by foreign investors. During the quarter, investor sentiment in Malaysia and in the Asian region was affected by concerns over impact of higher energy prices and US economic slowdown on growth prospects in the region.

The international reserves of Bank Negara Malaysia amounted to RM410.9 billion (equivalent to USD125.8 billion) as at 30 June 2008. The reserves amounted to RM403.9 billion (equivalent to USD123.7 billion) as at 15 August 2008. The reserves position is sufficient to finance 9.7 months

of retained imports and is 5 times the short-term external debt.

OPR was left unchanged

The Overnight Policy Rate (OPR) was left unchanged at 3.50% throughout the second quarter. The Bank is projecting inflation to remain elevated in the second-half of 2008 and into early next year before moderating towards mid-2009. The major restructuring of domestic energy prices in June is expected to have a deflationary effect on the economy in the second half of this year and into the early part of 2009.

With the OPR unchanged, 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 6.08% as at end-June. Deposit rates remained relatively stable during the period.

Financing activity in the second quarter remained strong and supported domestic economic activity. On a net basis, banking system loans and PDS outstanding expanded by 14.1% at end-June. Loans outstanding increased by 11.7% at end-June, reflecting increases for both the business and household sectors, with loans outstanding to these sectors expanding at 14.4% and 8.9% respectively. Loan applications, approvals and disbursements remained at relatively high levels, with continued broad-based financing to productive sectors of the economy.

Net funds raised in the capital market were significantly higher in the second quarter, amounting to RM27.7 billion. In the private sector, net funds raised through the PDS market were higher at RM15 billion, while net funds raised through the equity market amounted to RM1.7 billion. Net funds raised by the public sector amounted to RM11 billion.

M3, or broad money, expanded by RM16.1 billion during the quarter, increasing at an annual rate of 14.2% at end-June. The increase during the quarter was mainly due to higher lending to the private sector.

During the second quarter, the ringgit depreciated by 2.4% against the US dollar. The US dollar strengthened during this period on expectations for a pause in Fed Funds rate cuts. In addition, higher global fuel and food prices and prospects of moderation in growth dampened investor sentiments towards the region, prompting portfolio outflows, affecting the regional currencies, including the ringgit. The ringgit depreciated against the euro (-2.3%) and the pound sterling (-2.3%), but appreciated against the Japanese yen (3.8%). The ringgit exhibited a mixed performance against other regional currencies. During the period 1 July to 28 August 2008, the ringgit depreciated against the US dollar (-3.2%) and the Japanese yen (-0.5%), but appreciated against the euro (3.3%) and the pound sterling (5%). The ringgit depreciated against most regional currencies in the range of 1.4% to 4%, with the exception of the Singapore dollar and Korean won against which the ringgit appreciated by 0.4% and 0.3% respectively.

Banking system remained resilient

The banking system continued to exhibit resilience and is well-positioned to support the financing and financial services needs of the domestic economy. As at end-June 2008, the banking system remained well-capitalised with risk-weighted capital ratio (RWCR) and core capital ratio (CCR) of 13% and 10.1% respectively. The banking system recorded

a pre-tax profit (PBT) of RM5.2 billion during the quarter, with annualised average returns on assets and equity of 1.7% and 22% respectively. Meanwhile, net non-performing loans (NPL) based on 3-month classification declined further by 6.7% to RM17.8 billion to account for 2.7% of total net loans.

Growth going forward

Going forward, the international economic and financial environment is expected to be more challenging. Global growth is projected to weaken further with a more protracted slowdown in a number of the developed economies and some moderation in growth in the emerging economies. While commodity and energy prices have experienced some correction in response to signs of slower global growth, prices remain elevated. Meanwhile, the international financial markets continue to remain fragile.

The domestic economy will be affected by these external developments. In addition, the impact of rising commodity and fuel prices and costs will continue to have a deflationary impact on domestic demand, as well as affecting consumer and business sentiments. Despite signs of moderating growth, the underlying fundamental strength of the Malaysian economy and the resilient banking sector provide the potential of the Malaysian economy to resume its steady growth path.

DEVELOPMENTS IN THE SECOND QUARTER OF 2008

INTERNATIONAL ECONOMIC ENVIRONMENT

Slower global growth with concerns of inflationary pressures

Economic expansion in the major industrialised economies continued to weaken in the second quarter. Growth in the Asian economies, while remaining favourable, also recorded some moderation. Meanwhile, inflationary pressures increased in most countries following higher energy and food prices.

In the **United States (US)**, real GDP expanded by a better-than-expected annualised 3.3% in the second quarter (1Q 08: 0.9%). Private consumption increased by 1.7% (1Q 08: +0.9%), while net exports contributed about 3.3 percentage points to growth. Growth was supported by a sustained expansion in consumer spending and greater contribution from net exports. Nonetheless, investment activity weakened, due mainly to a continued decline in residential investment which contracted for the tenth consecutive quarter. Revised data also showed that the US economy contracted by 0.2% in the fourth quarter of 2007 (previous estimate: +0.6%), with a sharper decline in the housing market than previously estimated. In terms of inflation, consumer prices rose by 4.3% (1Q 08: 4.2%) largely on account of higher energy and food prices.

In **Japan**, real GDP declined by an annualised 2.4% in the second quarter (1Q 08: +3.2%), as private consumption, investment and exports contracted on a quarterly basis. Private consumption decreased by 0.5% quarter-on-quarter (q-o-q) as consumers were affected by the rising inflationary pressures and weak labour market conditions. Meanwhile, residential investment and capital spending declined by 3.4% and 0.2% q-o-q respectively. Exports, which was the main driver of growth for the previous few quarters, fell by 2.3% q-o-q as the decline in exports to the US and Europe offset firm export growth to emerging markets. On the inflation front, prices rose by 1.4% (1Q 08: 1.0%), with core prices remaining within positive territory for the ninth consecutive month.

In the **euro area**, economic activity contracted in the second quarter by 0.2% q-o-q from an expansion of 1.3% q-o-q in the first quarter. Meanwhile, the year-on-year growth slowed for the third consecutive quarter to 1.5% (1Q 08: 2.1%). Growth was mainly affected by a slowdown in the major euro area economies. Germany, France and Italy contracted in the second quarter due to weak consumption activity and slowing exports, while Spain grew at a slower pace as the once booming construction industry continued to moderate. Meanwhile, in the

Industrial countries: Real GDP Growth

	2007		2008		Key contributing factors for 2Q growth	
	2Q	1H	1Q	2Q		1H
	Annual change (%)					
US ¹	1.8	1.6	0.9 ^r	1.9 ^a	0.9	Supported by growth in consumer spending and greater contribution from net exports.
Japan ¹	-1.7	2.5	3.2	-2.4 ^p	1.6 ^p	Declined due to weakening private consumption, investment and exports.
Euro area	3.2	2.9	2.1	1.5 ^p	1.9 ^p	Weak consumption activity in Germany, France and Italy and a construction slump in Spain.
UK	3.1	3.2	2.3	1.6 ^p	2.5 ^p	Slower growth due to decline in construction activity and industrial production.

¹ Annualised basis

^a Advanced estimate

^r Revised

^p Preliminary

Source: National authorities

UK, economic growth in the second quarter slowed significantly to 1.6% (1Q 08: 2.3%), due mainly to weakness in the construction sector and weaker growth in manufacturing activity. Headline inflation in both the euro area and UK rose by 3.6% and 3.3% respectively in the second quarter, due mainly to rising energy and food prices.

In the **US**, the **Federal Open Market Committee** (FOMC) lowered the Federal Funds rate by 25 b/p to 2.0% on 30 April. Thereafter, the rate was maintained on concerns of slowing growth despite higher inflation. Headline inflation in July recorded an increase of 4.9%, the fastest pace since 1991. However, the FOMC emphasised that economic growth in the coming quarters would be affected by the continued deterioration in the housing market and high energy prices.

Increased concerns over the two government-sponsored housing mortgage enterprises (GSEs), namely Fannie Mae and Freddie Mac, prompted the US Congress to approve the Housing and Economic Recovery Act of 2008 in July 2008. The bill contains provisions to support the GSEs, including allowing temporary authority for the US Treasury to purchase debt

securities and stocks issued by the GSEs and increased credit lines.

During the second quarter, interest rates were maintained in other industrial economies. The **Bank of Japan** kept interest rates at 0.5% despite rising consumer prices as weaker external demand conditions had increased the risks to economic growth. The **European Central Bank** (ECB) maintained interest rate at 4%, but later raised rates by 25 basis points to 4.25% in July as inflation breached 4% in June, 2% above the ECB target. The **Bank of England** (BoE) continued to maintain interest rates at 5%, balancing concerns over rising inflation against the increasing risk of a sharper economic slowdown.

In the commodities market, global **crude oil prices**¹ rose significantly, and averaged USD123.93 per barrel (1Q 08: USD97.70 per barrel) in the second quarter. Oil prices reached a new intra-day record high of USD147.12 on 11 July following a weak US dollar as well as concerns over supply disruptions in Iran, Nigeria and Brazil. Oil prices since have begun to retreat, falling below USD120 per barrel by early August, weighed down by a stronger US dollar, proposed measures to curb speculative activities and signs of slower global growth.

Regional Countries: Real GDP Growth

	2007		2008			Key contributing factors for 2Q growth
	2Q	1H	1Q	2Q	1H	
	Annual change (%)					
PR China	12.6	12.2	10.6	10.1	10.4	Lower growth due to declining contribution from net exports.
Indonesia	6.3	6.1	6.3	6.4	6.4	Strong growth in exports due to high commodity prices.
Thailand	4.2	4.3	6.1	5.3	5.7	Lower growth due to weak consumption and investment.
Korea	4.9	4.5	5.7	4.8 ^a	5.3	Strong expansion in exports despite a weaker domestic demand.
Philippines	7.0	7.7	4.7	4.6	4.7	Growth supported by strong investments.
Chinese Taipei	5.2	4.7	6.3	4.3	5.3	Driven mainly by strong exports demand from emerging markets.
Hong Kong SAR	6.4	6.0	7.3	4.2	5.8	Moderation in growth due to weaker external and domestic demand.
Singapore	9.1	8.0	6.9	2.1	4.5	Lower growth due to sharp contraction in biomedical manufacturing.

^a Advanced estimate
Source: National authorities

¹ Refers to WTI one-month futures on NYMEX

In the **Asian region**, economic growth in several regional economies moderated in the second quarter due to softer domestic demand and slower exports. Regional growth continued to be led by PR China, which posted a strong, albeit lower growth of 10.1% (1Q 08: 10.6%), due mainly to lower contribution from net exports. During the quarter, several national authorities in the region had responded to the significant rise in crude oil prices by raising domestic retail fuel prices. Thus, while growth in most regional economies moderated, regional inflationary pressures remained high due to rising fuel and food prices. Amidst these developments, several regional authorities have also announced measures to alleviate the burden of rising prices, particularly on the lower income group. To counter inflation, a number of Asian central banks shifted towards a tightening cycle.

In the **foreign exchange market**, the US dollar ended the quarter stronger against the euro and Japanese yen, but depreciated slightly against the pound sterling following heightened expectations for interest rate hike by BoE. Meanwhile, regional currencies displayed a mixed performance, with most Asian currencies recording a modest depreciation as high food and fuel prices raised concerns over the impact of inflation on growth. Beginning the third quarter, the US dollar has begun to show a broad-based strengthening.

While the global economy performed better-than-expected in the first half of 2008, global growth is expected to slow in the second half 2008. Downside risks to growth will continue to persist amidst signs of sharper slowdown in industrial economies as well as the prevailing uncertainties in the global commodities and financial markets.

DEVELOPMENTS IN THE MALAYSIAN ECONOMY

Sustained growth momentum supported by stronger exports

The Malaysian economy registered a growth of 6.3% (1Q 08: 7.1%) in the second quarter of 2008. Growth was supported by stronger export performance, while domestic demand expanded at a more moderate pace in an environment of higher prices and costs. On the supply side, growth was driven by the key sectors of the economy.

Domestic demand moderated

Domestic demand moderated to 7.8% in the second quarter (1Q 08: 10%) reflecting mainly the effects of higher prices and more cautious outlook by consumers and businesses.

	2007		2008		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
Aggregate Domestic Demand (excluding stocks)	10.2	9.1	10.0	7.8	8.9
Consumption	11.9	9.7	11.5	8.6	10.0
<i>Private sector</i>	12.3	9.9	11.7	9.0	10.3
<i>Public sector</i>	10.4	9.0	10.5	7.1	8.7
Gross Fixed Capital Formation	6.0	7.6	6.0	5.6	5.8
Net Exports	10.3	-2.1	26.4	20.0	23.1
<i>Exports of Goods and Services</i>	3.4	2.9	6.0	9.7	7.9
<i>Imports of Goods and Services</i>	2.6	3.6	3.4	8.4	5.9
GDP	5.7	5.6	7.1	6.3	6.7

Source: Department of Statistics, Malaysia

Private consumption expenditure grew by 9%. Although major consumption indicators such as credit card spending, imports of consumption goods as well as loans disbursed to households pointed to higher nominal consumer spending activities during the quarter, growth of private consumption in real terms moderated due to higher prices of consumer goods, particularly

in May and June. Concerns over rising prices following the subsidy restructuring also had affected consumer sentiments as reflected by the drop in the MIER Consumer Sentiment Index to 70.5 points during the quarter (1Q 08: 115.5 points).

Public consumption continued to record a growth of 7.1% due to higher expenditure on emoluments, defence, supplies and services.

Gross fixed capital formation was sustained at 5.6% in the second quarter (1Q 08: 6%). Investment activity was supported by the continued inflow of foreign direct investment, mainly into the services and manufacturing sectors. While indicators such as imports of capital goods pointed to continuing investment activities, the higher cost of capital goods has moderated investment spending in real terms. In addition, business sentiments as indicated by the MIER Business Conditions Index moderated slightly to 114.1 points (1Q 08: 119.9 points). Meanwhile, the development expenditure of the government was higher, channelled mainly into education, improvement of public utilities, social welfare services and transport infrastructure.

Business confidence moderated slightly while consumer sentiment declined significantly



Growth supported by the key sectors of the economy

On the sectoral front, the key sectors of the economy contributed positively to growth, except for mining. The services sector benefited from trade, finance and consumption-related activities. Strong performance in domestic-oriented industries led the growth in the manufacturing sector, while growth in the agriculture sector was underpinned by double-digit expansion in crude palm oil output. The construction sector grew at a moderate pace amidst an environment of rising cost of building materials. Meanwhile, the mining sector contracted slightly due to lower output of natural gas.

Quarterly GDP by Kind of Economic Activity at Year 2000 Prices

	2007		2008		
	2Q	1H	1Q	2Q	1H
	Annual change in (%)				
Agriculture	-1.5	1.0	6.3	5.9	6.1
Mining	7.8	3.5	3.7	-0.5	1.6
Manufacturing	1.5	1.8	7.0	5.6	6.3
Construction	4.8	4.5	5.3	3.9	4.5
Services	9.4	9.4	7.9	7.6	7.8
Real GDP (Annual Change)	5.7	5.6	7.1	6.3	6.7
Real GDP (Preceding Change)	3.1	0.0	-1.8	2.3	-0.3

Source: Department of Statistics, Malaysia

Strong performance in services sector

The **services sector** expanded by 7.6% led by strong growth in the wholesale and retail trade as well as favourable performance in the communication; transport and storage; and finance and insurance sub-sectors.

The **wholesale and retail trade** sub-sector recorded a higher growth of 12.6% (1Q 08: 11.9%), supported by continued consumption activities, especially in the motor vehicle segment as well as higher tourism activities. Similarly, growth in the **communication** sub-sector was higher, driven by strong demand for voice and data services, particularly from the broadband segment.

Meanwhile, growth in the **transport and storage** sub-sector was sustained due to strong trade-related activities. Growth in the **finance and insurance** sub-sector remained favourable (7.5%; 1Q 08: 9.9%), supported by lending activities as well growth in the fee-based and insurance segments.

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

	Share 2007 (%)	2007		2008		
		2Q	1H	1Q	2Q	1H
		Annual change in (%)				
Intermediate Services	43.7	11.8	12.3	8.4	6.9	7.6
Finance & insurance	19.9	11.6	12.6	9.9	7.5	8.7
Real estate & business services	9.8	17.4	19.9	4.8	3.9	4.4
Transport & storage	7.0	9.0	7.3	9.9	8.1	9.0
Communication	7.0	8.1	6.7	7.5	7.9	7.7
Final Services	56.3	7.7	7.2	7.5	8.2	7.9
Electricity, gas & water	5.6	5.6	4.9	4.6	4.1	4.4
Wholesale & retail trade	22.8	12.1	10.7	11.9	12.6	12.3
Accommodation & restaurant	4.4	10.4	9.1	10.0	7.3	8.6
Government services	12.9	2.9	4.6	2.8	5.1	4.0
Other services	10.6	5.1	4.4	5.0	5.4	5.2
Total Services	100.0	9.4	9.4	7.9	7.6	7.8

Source: Department of Statistics, Malaysia

Selected Quarterly Indicators in the Services Sector

	2007				2008	
	1Q	2Q	3Q	4Q	1Q	2Q
	Percentage at end-period (%)					
Cellular phone penetration rate	77.0	78.2	80.8	85.1	87.9	90.6
Internet <i>dial-up</i> subscribers penetration rate	14.0	14.2	14.3	14.3	14.5	14.4
Broadband subscribers penetration rate	3.7	4.1	4.5	5.0	5.4	5.5
	Index					
MIER Consumer Sentiment Index	124.1	115.9	117.5	110.7	115.5	70.5
MIER Retail Trade Index	118.8	129.5	145.9	141.2	106.1	94.5
MIER Tourism Market Index	133.8	131.6	131.1	133.6	120.3	107.5
	Annual change (%)					
Total consumption credit outstanding	7.8	7.4	7.1	7.3	7.2	9.6
Loans outstanding to the wholesale & retail trade, hotels & restaurants	1.8	-0.2	6.1	7.2	10.5	15.4
Imports of consumption goods	8.9	1.1	1.2	3.8	5.6	21.1
Total sales of motor vehicles	-15.3	-9.1	4.9	19.0	24.6	27.1
Container cargo handled (Port Klang and PTP)	18.5	12.2	9.7	14.4	9.7	9.4

Source: Various sources

Domestic-oriented industries supported the manufacturing sector

Value-added growth in the manufacturing sector expanded by 5.6% (1Q 08: 7%), supported by strong performance of the domestic-oriented industries as well as selected resource-based industries which are export-oriented.

Growth of **domestic-oriented industries** remained strong, expanding by 12.9% (1Q 08: 14.8%), driven by higher production in transport equipment, food and construction-related materials industries. The transport equipment industry benefited from the strong sales of new motor vehicles, while the construction-related materials industry was supported by strong regional demand and continued growth in the domestic construction sector.

Production of **export-oriented industries** moderated to grow by 2.1% during the quarter (1Q 08: 4.6%) on the lower output of computers and parts as demand from US slowed and production of petroleum and basic chemical products declined due to lower output of natural gas during the quarter. Nevertheless, output in electronics and electrical products (E&E) industry was sustained, driven predominantly by higher external demand for electrical products, particularly audio visual products, and semiconductors. Output of semiconductors was in line with the rising trend of global

Performance in the Manufacturing Sector

	2007		2008		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
Value Added (Constant Price)	1.5	1.8	7.0	5.6	6.3
Overall Production	0.1	0.4	6.6	4.3	5.4
Export-oriented industries	-1.6	-0.9	4.6	2.1	3.3
<i>Of which:</i>					
Electronics and electrical	-5.8	-5.6	3.1	2.9	3.0
Electronics	-4.0	-4.0	3.9	2.7	3.3
Electrical	-11.1	-10.7	0.5	3.6	2.0
Chemicals and chemical products	1.3	4.2	4.3	2.0	3.2
Petroleum products ¹	11.3	8.1	8.2	-2.0	3.1
Rubber products	2.7	9.5	2.4	6.0	4.2
Off-estate processing	-12.7	-7.5	20.2	18.1	19.1
Domestic-oriented industries	6.8	5.9	14.8	12.9	13.8
<i>Of which:</i>					
Construction-related materials ²	7.2	5.3	14.6	8.4	11.3
Fabricated metal products	22.0	22.0	16.0	13.6	14.7
Transport equipment	-12.8	-17.4	25.7	28.4	27.1
Food	7.6	11.7	8.9	11.0	10.0

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

semiconductor sales following continued demand for electronic products. Meanwhile, selected **resource-based industries** such as off-estate processing and rubber products continued to lend some support to the export-oriented industries. The strong growth in the off-estate processing industry was in tandem with the production of crude palm oil, while the rubber products industry was underpinned by higher external demand for rubber gloves.

The overall **capacity utilisation** in the manufacturing sector remained unchanged at 78% in the second quarter, with the export-oriented and domestic-oriented industries operating at 79% and 75% respectively (1Q 08: 79% and 74% respectively).

Strong growth in the agriculture sector

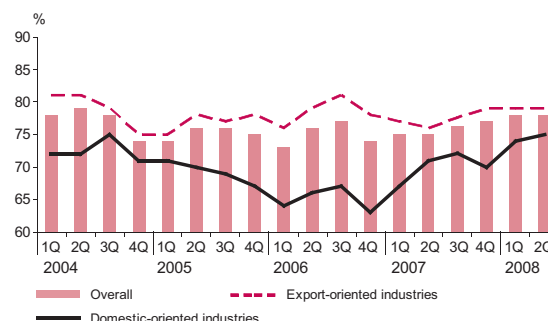
The **agriculture sector** continued to record a strong growth of 5.9% in the second quarter, driven by double-digit growth in crude palm oil production (21.8%), and further supported by better performance in paddy, livestock and fisheries sub-sectors. The **mining sector**, however, recorded a marginal decline due to lower output of natural gas. However, crude oil production (including condensates) increased by 0.7% during the quarter to 681,104 barrels per day.

Performance in the Mining Sector

	2007		2008		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
Value Added (at year 2000 prices)	7.8	3.5	3.7	-0.5	1.6
Production					
Of which:					
Crude oil and condensates	4.6	0.5	7.0	3.6	5.3
Natural gas (net)	8.5	5.8	-1.2	-6.8	-4.0
Exports (RM million)					
Of which:					
Crude oil and condensates	-6.1	-7.3	49.6	63.7	56.8
Liquefied natural gas	28.8	14.9	24.7	34.8	29.6

Source: PETRONAS
Department of Statistics, Malaysia

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

Performance in the Agriculture Sector

	2007		2008		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
Value Added (at year 2000 prices)	-1.5	1.0	6.3	5.9	6.1
Industrial Crops	-4.6	-0.7	9.1	7.2	8.1
Food Crops	3.1	3.5	2.5	4.2	3.4
Production					
Of which:					
Crude palm oil	-13.3	-8.0	23.9	21.8	22.8
Rubber	1.4	-3.3	-2.1	-6.9	-4.3
Fish	-4.5	-0.6	0.4	1.9	1.2
Livestock	12.8	15.5	0.9	4.1	2.4
Exports (RM million)					
Of which:					
Palm oil	39.5	29.4	100.9	84.5	91.5
Rubber	-18.0	-15.6	30.8	21.8	26.2
Sawn timber	-1.8	2.7	-16.5	-22.0	-19.2
Saw logs	-3.4	-7.0	-1.7	10.5	4.6

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

Moderate growth in the construction sector

The **construction sector** expanded by 3.9% during the quarter (1Q 08: 5.3%) as the uncertainty on prices of building materials led to moderation in growth in the civil engineering sub-sector. However, the overall growth was supported by the residential sub-sector, particularly in the high-end segment. The non-residential segment continued to be supported by demand for office space, especially in Kuala Lumpur.

	2007		2008		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
New sales and advertising permits	-6.3	0.4	-6.4	10.9	2.0
Housing approvals	-24.8	-17.5	10.6	28.5	19.1
Production of construction-related materials	7.2	5.3	14.6	8.4	11.3
Loans approved for construction	103.8	94.8	74.4	-12.4	20.5
Imports of construction materials and mineral products	8.4	10.4	8.3	6.4 ¹	7.5 ²

¹April-May 2008
²January-May 2008
Source: Ministry of Housing and Local Government and Department of Statistics, Malaysia

Inflation was higher in the second quarter

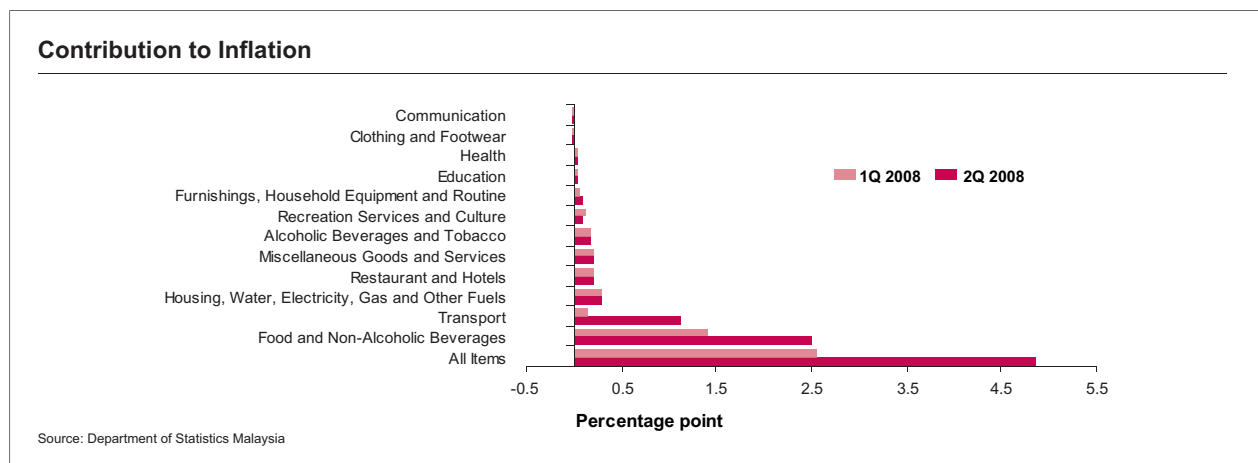
Headline inflation rose to 4.8% in the second quarter (1Q 08: 2.6%) mainly reflecting higher prices in the transport and food categories. Prices in the transport category increased by an average of 7.1% (1Q 08: 0.9%), primarily as a result of the new retail prices for petrol and diesel announced by the Government on 4 June 2008.

Prices in the food and non-alcoholic beverages category rose by 8% during the period, accounting for 52% of the overall inflation rate. High domestic rice prices, following soaring global rice prices contributed to the increase. Nevertheless, since May 2008 international rice prices have softened and are expected to limit further upward pressures on domestic rice prices. Meanwhile, price increases were also recorded in the alcoholic beverages and tobacco; restaurants and hotels; and miscellaneous goods and services categories.

In contrast, prices were lower in the communication; and clothing and footwear categories, reflecting the strong competition among producers in both markets. The price declines in these categories moderated the rise in headline inflation.

Headline inflation is expected to remain at elevated levels from June 2008, before beginning to moderate towards the middle of 2009.

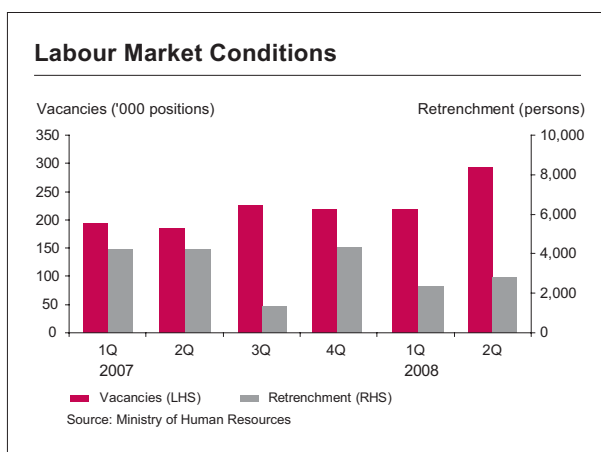
Producer price index (PPI) inflation increased to 12.3% (1Q 08: 9.7%) due to higher prices in both the commodity and non-commodity-based components of the PPI. Price increases in the commodity-based PPI components remained high due to elevated global prices for raw materials such as crude oil, rubber and crude palm oil. Meanwhile, prices in the non-commodity-based PPI components increased at a faster pace, reflecting increased cost pressures facing domestic producers.



In terms of composition, prices in the local component of the PPI increased to 15.4% (1Q 08: 11.2%). This reflected higher prices in the food and live animals; mineral fuels, lubricants and related materials; and chemical and related product categories. However, the imported component of the PPI rose at a slower rate of 6.1% (1Q 08: 6.6%) due to slower price increases mainly in the machinery and transport equipment; and manufactured goods classified chiefly by material categories.

Labour market conditions remained stable

While there was a marginal increase in retrenchments, overall labour market conditions remained stable in the second quarter, supported by firm labour demand and higher productivity growth in the manufacturing sector as a result of higher sales recorded during the quarter. Labour demand for all levels of skills continued to be strong, as reflected by the higher number of vacancies in the Electronic Labour Exchange (292,934 positions; 1Q 08: 219,366 positions). Broadly, there were more job openings in the services (33% share), manufacturing (32%) and agriculture (26%) sectors. Meanwhile, vacancies for graduates were concentrated in the financial sector.

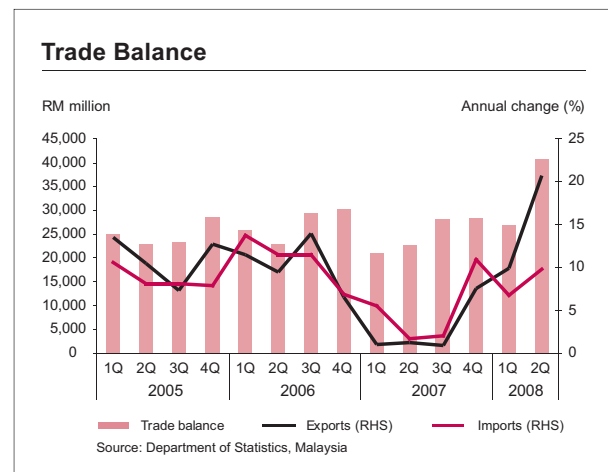


Total retrenchments increased slightly to 2,821 persons during the quarter (1Q 08: 2,397 persons), due mainly to lay-offs in the manufacturing sector (74% of retrenchments), and in the distributive trade, restaurants and hotels sub-sector (14% share). One-third of the retrenched workers were plant and machine operators and assemblers, while general workers constituted 28%.

Strong export growth, largely contributed by high commodity prices

Exports grew strongly by 20.8% in the second quarter, led by continued strong growth in commodity and resource-based manufactured exports and reinforced by recovery in exports of E&E. Import growth was also higher at 9.8%. As exports outpaced imports, the **trade surplus** increased further to RM40.8 billion.

The robust **agriculture exports** were driven mainly by higher export prices. Export earnings from palm oil rose by 84.5% due mainly to higher prices (RM3,524 per tonne) and to some extent from higher export volume. Rubber exports, benefiting from significantly higher export prices, also contributed positively to the export growth. The sharp increase in agriculture prices was spurred by strong export demand



from the regional countries, the US and Japan, and as well as the surge in oil prices. Higher crude oil prices and liquefied natural gas also partially explained the strong growth in **mineral exports**. Export price of crude oil increased by 58.1% to record an average of USD116 per barrel.

Higher **manufactured exports** were due mainly to higher prices in resource-based products and semiconductors. Exports of resource-based products such as chemicals and chemical products, rubber products and petroleum products increased further, benefiting from strong commodity prices and sustained demand. E&E exports recorded a positive growth after registering five quarters of negative growth. The improved performance in semiconductor exports was due to better global semiconductor prices and higher demand from PR China. Meanwhile, stronger exports of electrical products were attributed to higher demand from the PR China, Hong Kong SAR, Korea, Japan and US.

All categories of imports registered stronger growth in the second quarter. Growth in **intermediate imports** was in tandem with higher manufactured exports. **Capital imports** were supported by continued investment activities in the domestic economy, while strong growth in **consumption imports** reflected mainly continued consumption activities and high prices for imported consumer products such as processed food and beverages.

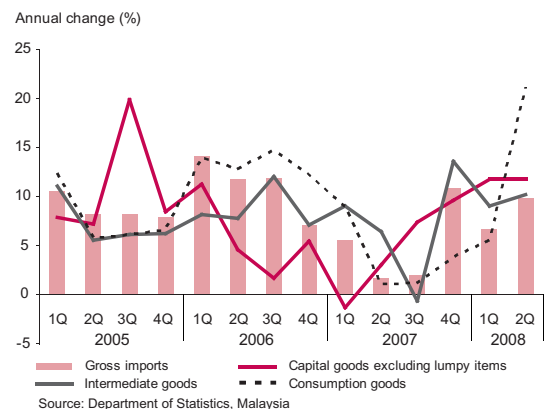
Trade Account

	2007		2008 ¹		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
Gross Exports	1.3	1.2	9.9	20.8	15.5
Manufacturing	-1.1	0.7	-1.9	12.3	5.3
E&E	-8.1	-5.9	-12.2	10.7	-0.7
Non-E&E	10.4	11.6	12.1	14.4	13.3
Agriculture	19.4	13.8	61.2	58.8	59.9
Minerals	7.2	-1.6	52.1	51.3	51.7
Gross Imports	1.7	3.6	6.8	9.8	8.3
Capital goods	-1.1	-3.2	7.8	11.7	9.9
Intermediate goods	6.5	7.7	9.0	10.2	9.6
Consumption goods	1.1	4.9	5.6	21.1	13.3
Trade balance (RM billion)	22.6	43.7	26.8	40.8	67.6

¹Malaysia's trade classification has been revised to reflect the revisions of the international trade codes i.e. Harmonised System (HS), ASEAN Harmonised Tariff Nomenclature (AHTN) and Standard International Trade Classification (SITC)

Source: Department of Statistics, Malaysia

Import Growth



Malaysia: Direction of Exports

	2007		2008			2007		2008		
	2Q	1H	1Q	2Q	1H	2Q	1H	1Q	2Q	1H
	Annual change (%)					Share of total exports (%)				
United States	-18.7	-11.5	-17.5	-0.1	-9.0	15.8	16.4	12.9	13.0	13.0
European Union (EU)¹	9.6	9.6	2.3	-3.5	-0.7	13.4	13.1	11.9	10.7	11.3
Selected ASEAN countries²	-4.8	-4.8	13.9	23.7	18.8	24.8	25.3	26.7	25.4	26.0
North East Asia	7.4	8.7	3.5	35.7	19.7	19.4	19.7	18.9	21.8	20.5
People's Republic of China	18.0	25.5	12.5	55.3	34.4	8.1	8.1	8.3	10.4	9.4
Hong Kong SAR	-10.2	-13.0	-13.7	34.9	11.1	4.5	4.6	3.6	5.1	4.4
Chinese Taipei	4.6	9.5	-4.5	6.3	1.2	2.9	2.8	2.4	2.6	2.5
Korea	14.3	9.7	9.5	17.8	13.4	3.9	4.3	4.7	3.8	4.2
West Asia	19.7	20.9	25.5	38.5	32.6	3.3	3.1	3.4	3.8	3.6
India	13.9	10.5	24.1	39.8	32.3	3.2	3.2	3.5	3.7	3.6
Total exports	1.3	1.2	9.9	20.8	15.5	100.0	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

Larger FDI amidst reversal in portfolio investment

On a cash basis, gross inflows of **foreign direct investment (FDI)**² increased to RM12.2 billion (1Q 08: RM7.1 billion), due mainly to larger drawdown of inter-company loans from parent companies abroad and inflows of equity capital. The FDI inflows were channeled mainly into the services (74%), manufacturing (11%) and oil and gas (10%) sectors. FDI in the services sector reflected partly foreign acquisition of interests in two domestic banks and the commencement of operations by a new foreign takaful company, as well as continued investments in the wholesale and retail trade sub-sector. Meanwhile, FDI inflows in the manufacturing sector were channelled mainly into the E&E, solar panels, and downstream petroleum-related industries. After adjustments for gross outflows due mainly to repayments of the short-term loans, net FDI was higher at RM8.3 billion (1Q 08: RM2 billion).

Overseas investment by Malaysian companies recorded a net outflow of RM3.5 billion (1Q 08: - RM6.6 billion), mainly in the services and manufacturing sectors. In the services sector, overseas investments reflected mainly the acquisition of a strategic stake in the finance and insurance sub-sector, as well as investments in the real estate and business services sub-sector. Meanwhile, overseas investments in the manufacturing sector were mainly for the acquisition of a process equipment manufacturer, followed by investments in the E&E, automotive and chemical-related industries.

Portfolio investment registered a net outflow reflecting mainly the liquidation of both bonds and equities by foreign investors. During the quarter, investor sentiment was affected by continued volatility in the global financial markets amid concerns of slower growth in

the US and the lingering effects of the credit crisis, as well as concerns over the impact of high energy prices and rising cost of production on domestic growth prospects. These developments were also broadly experienced in other regional markets.

External debt remained manageable

As at end-June 2008, Malaysia's total external debt amounted to RM234.8 billion or USD71.2 billion (end-March 08: RM216.7 billion or USD67.1 billion), equivalent to 34.4% of GNI. The **medium- and long-term external debt** was higher at RM142.3 billion (end-March 08: RM135.1 billion), due mainly to a net drawdown by the private sector (+RM5.3 billion), largely by a non-resident controlled company to finance its investment as well as borrowings by companies in the manufacturing sector. Meanwhile, the public sector continued to record a net repayment (-RM0.4 billion) as repayment by the NFPEs more than offset a net drawdown by the Federal Government.

The total **short-term external debt** increased to RM92.5 billion or USD28.1 billion (end-March 08: RM81.6 billion or USD25.3 billion) due mainly to inter-bank borrowings arising from treasury operations. As at end-June 2008, the short-term debt remained low and accounted for 22.5% of the net international reserves.

External Debt Outstanding

	2008	
	1Q	2Q ^P
	RM billion	
Medium- and long-term debt	135.1	142.3
Public sector	75.3	75.6
Private sector	59.8	66.7
Short-term debt ¹	81.6	92.5
Total external debt	216.7	234.8
- USD billion equivalent	67.1	71.2

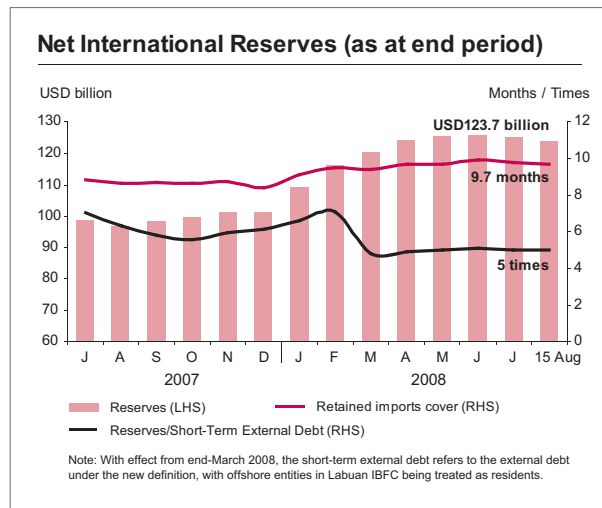
¹ Excludes currency and deposits held by non-residents with resident banking institutions
^P Preliminary

Source: Ministry of Finance, Malaysia and Bank Negara Malaysia

² The statistics for FDI on a cash basis does not include retained earnings and investment in the form of imported machinery and equipment.

International reserves

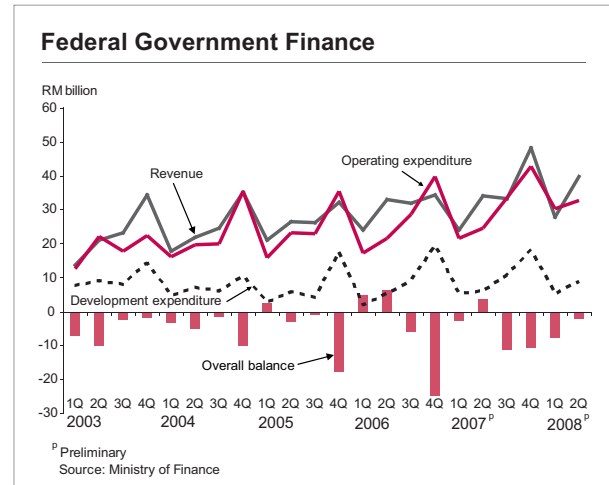
The international reserves of Bank Negara Malaysia amounted to RM410.9 billion (equivalent to USD125.8 billion) as at 30 June 2008. The reserves level as at 30 June 2008 has taken into account the quarterly adjustment of the foreign exchange revaluation gain, following the strengthening of the major currencies against ringgit during the quarter. The reserves amounted to RM403.9 billion (equivalent to USD123.7 billion) as at 15 August 2008. The reserves position is sufficient to finance 9.7 months of retained imports and is 5 times the short-term external debt.



Improved fiscal position

The Federal Government's fiscal deficit in the second quarter was lower at 1% of GDP (RM1.9 billion) as the rise in total revenue was larger than the increase in operating expenditure (1Q 08: fiscal deficit of 4.4% of GDP or RM7.7 billion). There was greater revenue collection from petroleum-based turnover and corporate income taxes. Total expenditure rose at an annual rate of 34.8% due to increases in both operating and development

expenditures. The deficit was financed mainly from domestic sources. As at end-June 2008, total outstanding debt of the Federal Government amounted to RM285.1 billion or 39.8% of GDP.



Federal Government Finance^P

	2007		2008		
	2Q	1H	1Q	2Q	1H
	RM billion				
Revenue	34.2	58.4	28.0	39.9	67.8
% growth	3.5	2.0	15.4	16.6	16.1
Operating expenditure	24.8	46.5	30.4	32.9	63.3
% growth	14.7	19.4	40.3	32.6	36.2
Current account	9.4	11.9	-2.5	7.0	4.5
% of GDP	6.1	4.0	-1.4	3.7	1.2
Gross development expenditure	6.2	11.6	5.3	9.0	14.3
% growth	19.6	57.0	-0.3	43.8	23.5
Overall balance	3.6	1.0	-7.7	-1.9	-9.6
% of GDP	2.3	0.3	-4.4	-1.0	-2.6
Memo item:					
Total gross expenditure	31.0	58.0	35.7	41.8	77.6
% growth	15.7	25.4	32.3	34.8	33.7
Total Federal Government debt (as at end-period)	260.1	260.1	275.1	285.1	285.1
% of GDP	40.5	40.5	38.4	39.8	39.8
Domestic debt	236.3	236.3	256.8	266.8	266.8
% of GDP	36.8	36.8	35.9	37.3	37.3
External debt	23.8	23.8	18.2	18.4	18.4
% of GDP	3.7	3.7	2.5	2.6	2.6

^P Preliminary
Source: Ministry of Finance

MONETARY AND FINANCIAL DEVELOPMENTS

Interest rates were stable

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

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

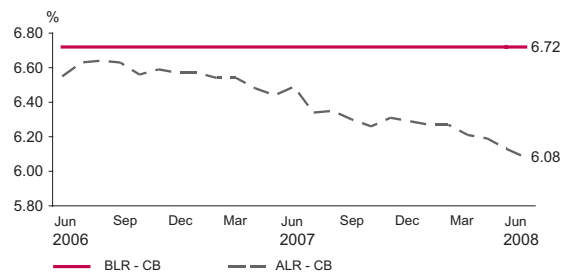
In terms of lending rates, the average base lending rate (BLR) of commercial banks (CBs) was unchanged at 6.72%. The average lending rate (ALR) on the other hand softened to 6.08% as at end-June, compared with 6.21% as at end-March.

The average quoted fixed deposit (FD) rates of CBs for tenures of between 1 to 12 months were relatively stable, ranging between 3.08% and 3.70% at the end of the second quarter. With the higher inflation since May, real FD rates have turned negative.

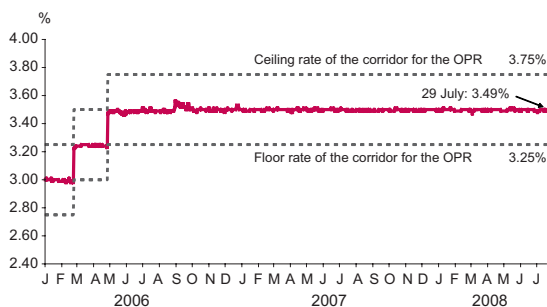
Interest Rates

	2007	2008	
	2Q	1Q	2Q
At end-period (%)			
Overnight Policy Rate (OPR)	3.50	3.50	3.50
Interbank rates			
Overnight	3.50	3.50	3.50
1-month	3.54	3.55	3.56
Base lending rates (BLR)			
Commercial banks	6.72	6.72	6.72
Average lending rates (ALR)			
Commercial banks	6.49	6.21	6.08
Fixed deposit rates			
Commercial banks			
3-month	3.17	3.14	3.14
12-month	3.71	3.70	3.70

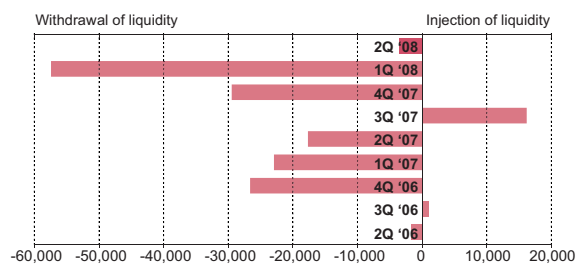
Lending Rates of Commercial Banks (Average for the period)



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, continued on its upward trend since the beginning of 2008, rising at an annual rate of 14.2% as at end-June 2008. During the quarter, M3 expanded by RM16.1 billion.

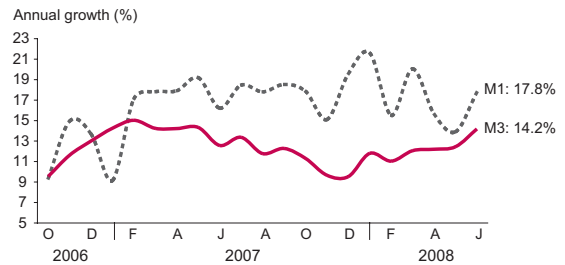
In contrast with the previous quarters, the growth in M3 was underpinned by a strong increase in lending to the private sector. Consequently, lending to the private sector outweighed the contribution of external sector in driving M3 growth. While the external sector remained expansionary on M3, the pace of inflows slowed during the second quarter, as trade-related inflows were partially offset by Malaysian investments abroad and portfolio outflows. Government operations exerted a small contractionary impact, reflecting fund raising activity conducted in the second quarter.

M1, a measure of transactional balances, rose at an annual rate of 17.8% at end-June (end-March 08: 20%), reflecting the strength of economic activity during the second quarter.

Gross private sector financing remained strong

Financing activity in the second quarter remained strong and supported domestic economic activity. Gross financing to the private sector through the banking system and the capital market continued to increase and amounted to RM184.4 billion (1Q 08: RM159.1 billion). This reflected higher loan disbursements and the issuances of private debt securities (PDS). On a net basis, banking system loans and PDS outstanding expanded by 14.1% at end-June (end-March 08: 12.7%).

Monetary Aggregates

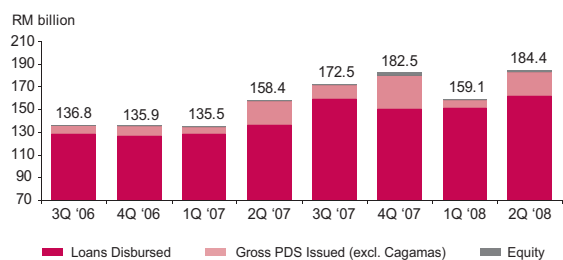


Determinants of Broad Money, M3

	Change during the period			
	2007		2008	
	2Q 07	Year	1Q 08	2Q 08
	RM billion			
M3	-0.6	72.4	51.7	16.1
Net claims on Government	-20.7	-0.6	0.9	-4.5
Claims on private sector	16.1	50.6	17.1	26.3
Loans	12.8	48.1	16.6	23.2
Securities	3.2	2.5	0.5	3.1
Net external operations ¹	40.2	77.5	45.8	4.2
BNM	31.5	50.9	52.5	15.9
Banking system	8.7	26.6	-6.7	-11.7
Other influences	-36.1	-55.0	-12.2	-9.8

¹ Pre-revaluation

Gross Private Sector Financing through Banking System and Capital Market



Financing of the Private Sector through Banking System and Capital Market

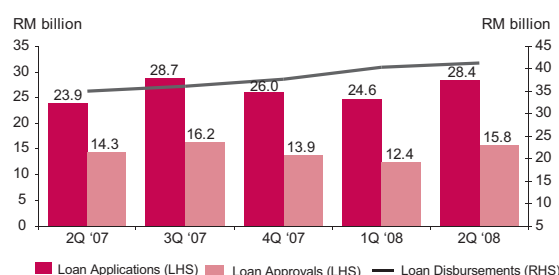
	During the period (RM billion)				Annual growth (%)		
	2007	2Q 07	1Q 08	2Q 08	2007	1Q 08	2Q 08
Gross total financing	648.9	158.4	159.1	184.5	17.4	17.4	16.5
Loans disbursed*	575.3	136.7	151.5	162.4	10.6	17.2	18.7
Gross PDS (excl. Cagamas)	66.5	20.6	6.5	20.4	116.4	26.6	-0.7
Equity	7.1	1.0	1.1	1.7	272.0	-2.2	62.4
Outstanding total financing (A)+(B)	84.0	26.0	22.8	40.8	10.7	12.7	14.1
Banking system	59.7	16.5	17.2	26.8	9.3	10.7	12.0
<i>Loans outstanding (A)</i>	51.2	12.5	17.4	24.3	8.6	10.0	11.7
<i>Holding of PDS</i>	8.5	4.0	-0.1	2.5	17.6	19.6	15.2
PDS outstanding (B)	32.7	13.5	5.5	16.5	17.1	21.4	21.5
Memorandum item							
Gross PDS (incl. Cagamas)	67.6	20.6	10.0	23.2	113.0	60.4	12.8

*Banking system loans include loans sold to Cagamas

Of significance, loans outstanding increased markedly, expanding by 11.7% at end-June (end-March 08: 10%). This expansion reflected increases for both the business and household sectors. Loans outstanding to the business and household sectors expanded at 14.4% and 8.9% respectively (end-March 08: 11.3% and 8.2% respectively).

In the business sector, loan applications and approvals registered negative growth rates due to the high base effect from a large syndicated bridging finance facility provided during the same period in 2007. Nevertheless, the amount of loans applied and approved remained at high levels during the quarter due to higher financing requirements for working capital. Business loan disbursements continued to register a strong double-digit annual growth rate, with funds channeled mainly to the manufacturing; and wholesale, retail, restaurants and hotels sectors.

Bank Lending to SMEs



Loan disbursements to SMEs also registered sustained improvement. Of the total loans disbursed, 23% were directed to SMEs.

For the household sector, demand for loans remained sustained, as reflected by loan applications and approvals. Demand for financing was mainly for the purchase of residential property and passenger cars, and for personal use.

Loan Indicators

	During the period (RM billion)				Annual Growth (%)			
	2007	2Q 07	1Q 08	2Q 08	2007	2Q 07	1Q 08	2Q 08
Total								
Loan applications	457.5	119.5	112.1	128.1	52.1	57.2	34.2	7.2
Loan approvals	298.6	83.2	71.7	80.3	58.6	75.0	35.0	-3.4
Loan disbursements	575.9	136.7	151.5	162.4	10.6	2.5	17.2	18.7
Loan repayments	518.6	123.0	138.9	139.7	8.5	2.6	17.7	13.5
Change in loan outstanding*	51.2	12.5	17.4	24.3	8.6	6.0	10.0	11.7
Of which:								
Business enterprises**								
Loan applications	262.6	72.1	56.5	64.8	63.1	75.5	25.8	-10.1
Loan approvals	181.5	53.9	38.1	40.9	88.4	125.4	27.6	-24.0
Loan disbursements	405.8	96.4	106.4	115.5	9.7	2.0	17.8	19.8
Loan repayments	370.3	87.4	97.5	99.2	5.3	-2.6	19.4	13.4
Change in loan outstanding*	24.5	5.8	7.6	14.1	10.3	6.0	11.3	14.4
SMEs**								
Loan applications	99.1	23.9	24.6	28.4	38.8	26.4	20.5	18.8
Loan approvals	55.1	14.3	12.8	15.9	37.1	42.4	19.4	11.0
Loan disbursements	141.7	35.0	40.3	41.3	5.6	-5.4	22.2	17.9
Loan repayments	126.8	31.9	35.1	35.8	3.5	-9.5	19.7	12.4
Change in loan outstanding*	9.5	1.6	4.6	3.2	9.1	5.7	10.0	11.3
Large corporations								
Loan applications	163.5	48.2	31.9	36.4	82.4	117.4	30.1	-24.5
Loan approvals	126.4	39.5	25.3	25.0	125.2	185.7	32.2	-36.7
Loan disbursements	264.1	61.5	66.1	74.3	12.1	6.7	15.2	20.8
Loan repayments	243.5	55.6	62.4	63.4	6.2	-15.3	19.2	14.0
Change in loan outstanding*	15.1	4.9	2.9	10.9	11.4	6.8	12.3	16.2
Households								
Loan applications	194.9	47.4	55.6	63.3	39.4	35.7	44.0	33.4
Loan approvals	117.1	29.3	33.6	39.4	27.3	24.0	44.4	34.5
Loan disbursements	169.5	40.3	45.1	46.8	12.8	3.9	16.0	16.3
Loan repayments	148.5	35.6	41.5	40.5	17.3	18.0	13.9	13.9
Change in loan outstanding*	24.5	5.9	6.2	8.6	7.4	7.2	8.2	8.9

* The annual growth is for end-period

** Include loans to individual businesses

Loans by Sector

	Loans disbursed					Loans out- standing	
	During the period				Share of total	Share of total	
	2007	2Q 07	1Q 08	2Q 08			
	(RM billion)				(%)		
Business enterprises	405.8	96.5	106.4	115.5	71.2	41.3	
Large corporations	264.1	61.5	66.1	74.3	45.7	23.5	
SMEs*	141.7	35.0	40.3	41.3	25.4	17.8	
<i>Selected sectors</i>							
Agriculture, hunting, forestry and fishing	14.1	3.3	3.7	4.3	2.6	2.2	
Mining and quarrying	2.0	0.6	0.5	0.8	0.5	0.3	
Manufacturing	134.9	32.7	36.2	39.8	24.5	11.9	
Construction	32.6	8.4	9.3	8.7	5.4	5.0	
Real estates	12.3	3.0	4.1	3.6	2.2	3.3	
Electricity, gas and water supply	1.3	0.3	0.8	0.5	0.3	0.6	
Wholesale, retail, restaurants and hotels	91.5	21.7	25.2	29.6	18.2	8.8	
Transport, storage and communication	32.1	4.4	2.7	4.0	2.4	2.6	
Finance, insurance and business services	45.7	13.5	14.3	15.0	9.2	6.3	
Households	169.5	40.3	45.1	46.8	28.8	54.0	
Purchase of residential properties	39.9	9.5	10.5	12.0	7.4	26.1	
Consumption credit	109.4	25.7	29.4	30.1	18.5	22.0	
<i>Of which:</i>							
Credit cards	57.9	13.8	14.7	14.4	8.9	3.4	
Purchase of passenger cars	27.8	6.2	8.4	9.6	5.9	14.4	
Others	20.2	5.1	5.3	4.8	2.9	5.9	
Total	575.3	136.7	151.5	162.4	100.0	100.0	

* Include loans to individual businesses.

Higher financing in the capital market

Net funds raised in the capital market were significantly higher in the second quarter, amounting to RM27.7 billion (1Q 08: RM12.5 billion).

During the quarter, the private sector raised more funds. Gross funds raised from the private debt securities (PDS) market increased in the second quarter to RM23.7 billion (1Q 08: RM10 billion). The significant increase was due to several large issuances, including those issued by a public-owned transportation company, a utility company, a construction company and two large financial institutions. During the quarter, there were also issuances by four non-resident corporations amounting to RM2.8 billion. The PDS issued during the period were mainly for funding new investments (75%) and for refinancing existing debts (14%).

Funds raised through the equity market increased slightly in the second quarter, amounting to RM1.7 billion (1Q 08: RM1.1 billion). A total of RM1.1 billion was raised through five initial public offerings (IPOs); three on the Second Board and two on MESDAQ, while the remaining funds were raised through rights issues and warrants. On a net basis, funds raised by the private sector amounted to RM16.7 billion during the quarter.

For the public sector, net funds raised amounted to RM11 billion (1Q 08: RM10.6 billion). Funds were raised through the re-opening of the 3-year and 5-year Malaysian Government Securities (MGS), as well as through an issuance of the 3-year Government Investment Issue (GII) and issuances of Merdeka Savings Bonds.

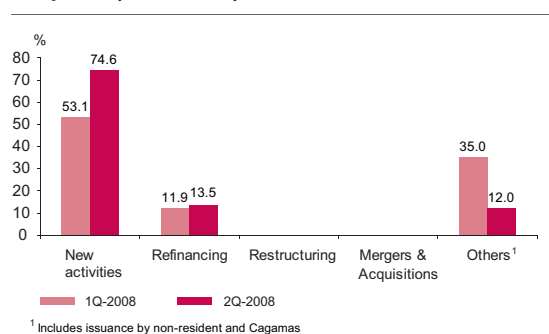
Secondary trading in the bond market increased

Total trading in the secondary market rose to RM153.2 billion in the second quarter (1Q 08: RM102.3 billion). Government securities (MGS and GII) accounted for 89% of the total trade. The MGS was the most liquid paper, registering a liquidity ratio of 0.63, followed by the GII with a liquidity ratio of 0.24.

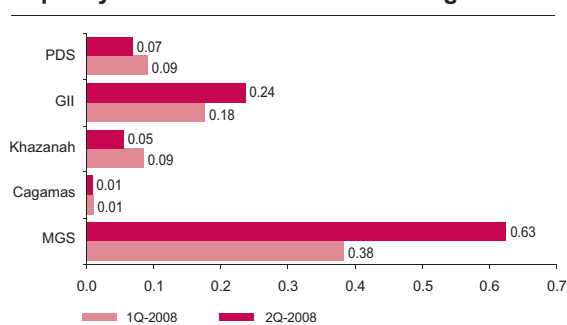
Funds Raised in the Capital Market

	2007		2008		
	2Q	1H	1Q	2Q	1H
	RM million				
By Public Sector	10,656	18,087	10,633	11,016	21,649
Government Securities, net	10,507	19,315	10,633	10,533	21,166
Malaysian Government Securities	9,107	19,215	14,283	7,033	21,316
Government Investment Issues	3,000	6,500	2,000	3,500	5,500
Less: Redemptions	1,600	6,400	5,650	-	5,650
Khazanah Bonds, net	524	(496)	-	(1,000)	(1,000)
Merdeka Savings Bond, net	(375)	(733)	-	1,483	1,483
By Private Sector	11,978	14,296	1,829	16,719	18,548
Shares	1,045	2,171	1,101	1,697	2,799
Debt securities, net	10,934	12,125	728	15,022	15,750
Private Debt Securities	20,971	28,553	9,996	23,749	33,746
Less: Redemptions	10,038	16,427	9,268	8,728	17,996
Total	22,634	32,383	12,462	27,735	40,197

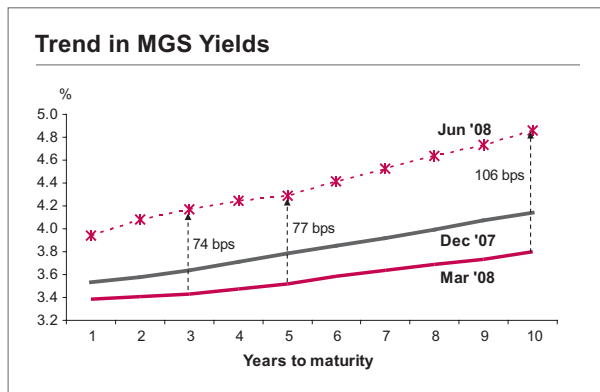
Private Debt Securities Issued by Purpose (% of total)



Liquidity Ratio: Turnover / Outstanding



MGS yields increased in the early part of June on heightened expectations for a rise in inflation. The increase in yields led to the widening of the spread between the 10-year MGS and the shorter and medium-term MGS. Bond yields, however, moderated in the last week of June as investors realised that the earlier sharp increase

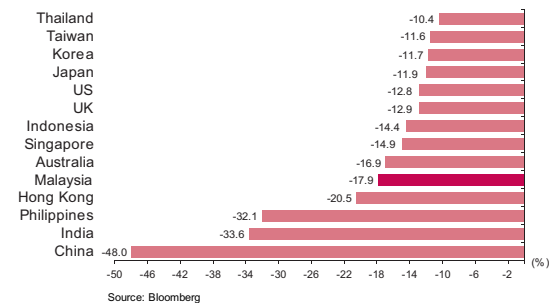


was excessive. As at end-June, the 10-year MGS yields have risen by 106 basis points since end-March 2008, while the 3-year and 5-year MGS have risen by 74 basis points and 77 basis points respectively.

KLCI declined in line with the other regional markets

In the second quarter, the KLCI weakened as in other regional equity markets due to the sustained increase in global crude oil prices and concerns over the extent of the US economic slowdown and its impact on the region. Market sentiments were also affected by the rising domestic inflationary pressures due to higher retail fuel and food prices. However, higher crude palm oil prices supported the plantation stocks and helped cushion the decline in the KLCI. The KLCI ended the second quarter lower at 1,186.6 (1Q 08: 1,247.5). Market capitalisation was lower at RM901.2 billion (1Q 08: RM952.3 billion) and trading activity decreased to a daily average turnover of 567.8 million units (1Q 08: 930.4 million units).

Performance of Selected Global and Regional Markets (31 December 2007 - 30 June 2008)



Bursa Malaysia: Selected Market Indicators

	As at end				
	2007		2008		
	2Q	1H	1Q	2Q	1H
Price Indices					
Composite	1,354.4	1,354.4	1,247.5	1,186.6	1,186.6
FBM30 ¹	8,587.9	8,587.9	8,232.9	7,656.7	7,656.7
FBMEMAS ²	9,107.9	9,107.9	8,423.7	7,900.4	7,900.4
Second Board	110.7	110.7	-	-	-
Mesdaq	137.7	137.7	-	-	-
FTSE Second Board	-	-	5,884.6	5,535.6	5,535.6
FTSE Mesdaq	-	-	4,923.2	4,404.8	4,404.8
Average daily turnover					
Volume (million units)	1,436.2	1,436.2	930.4	567.8	567.8
Value (RM million)	2,303.5	2,303.5	2,032.7	1,302.8	1,302.8
Market capitalisation (RM billion)					
	1,088.3	1,088.3	952.3	901.2	901.2
No. of companies listed					
	1,012	1,012.0	989	984	984

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

Source: Bursa Malaysia

On 28 August 2008, the KLCI closed at 1,070.5 (since end-2007: -25.9%), with market capitalisation lower at RM814.1 billion (since end-2007: -26.4%).

Bursa Malaysia: Turnover of Corporate Securities

	2007				2008					
	2Q		1H		1Q		2Q		1H	
	million units	RM million	million units	RM million	million units	RM million	million units	RM million	million units	RM million
Turnover	95,725	158,674	219,356	322,837	53,962	117,591	35,770	82,075	89,732	199,666
Of which:										
Main Board	66,832	141,026	157,698	285,686	36,488	111,119	28,251	79,725	64,739	190,844
Of which:										
Consumer Products	2,178	5,369	4,137	10,498	931	3,600	882	2,923	1,813	6,524
Industrial Products	8,212	12,247	17,386	24,771	3,409	6,970	3,332	6,195	6,741	13,166
Construction	5,265	13,885	12,952	31,655	4,722	13,820	3,317	6,352	8,039	20,173
Trading/Services	17,851	49,632	38,826	95,928	10,383	38,221	9,157	28,415	19,540	66,636
Finance	6,274	23,836	15,590	52,660	3,391	21,975	2,983	18,064	6,374	40,039
Properties	12,666	14,458	29,483	26,504	4,234	4,997	3,045	3,367	7,279	8,365
Plantations	2,148	11,348	3,598	19,986	2,262	13,816	1,520	9,847	3,782	23,663
Infrastructure	968	2,681	2,652	6,293	1,148	3,671	944	2,885	2,091	6,555
Second Board	11,838	8,579	20,600	13,793	4,098	3,035	2,360	1,448	6,458	4,483
Mesdaq	10,210	6,527	27,941	15,373	5,621	2,423	2,510	782	8,132	3,205

Source: Bursa Malaysia

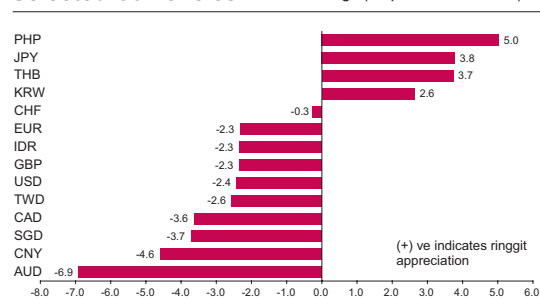
Exchange Rate Developments

During the second quarter, the ringgit depreciated by 2.4% against the US dollar. The strength of the US dollar during this period mainly reflected market expectations for a pause in Fed Funds rate cuts. In addition, higher global fuel and food prices dampened investor sentiments towards the region and led to portfolio outflows. The ringgit depreciated against the euro (-2.3%) and the pound sterling (-2.3%), but appreciated against the Japanese yen (3.8%). The ringgit exhibited a mixed performance against other regional currencies.

During the period 1 July to 28 August 2008, the ringgit depreciated against the US dollar (-3.2%) and the Japanese yen (-0.5%), but appreciated

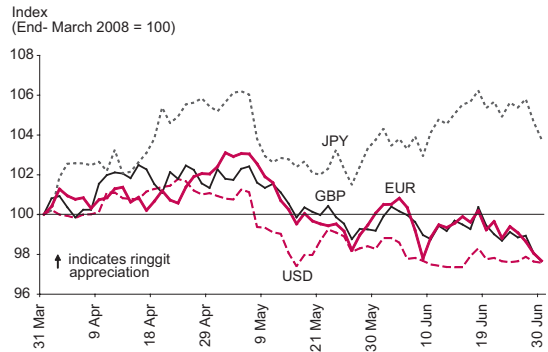
Summary of Ringgit Performance Against Selected Currencies

Percent Change (1 April - 30 June 2008)

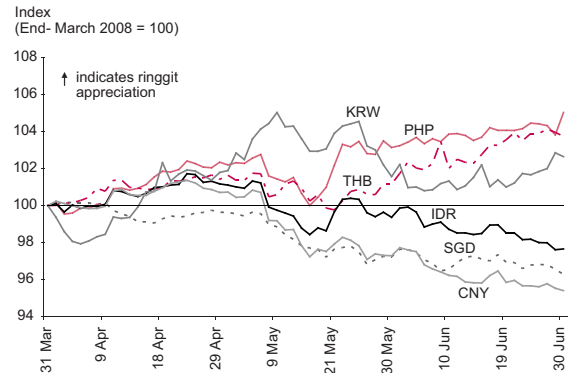


against the euro (3.3%) and the pound sterling (5%). The ringgit depreciated against regional currencies in the range of 1.4% to 4%, with the exception of the Singapore dollar and Korean won against which the ringgit appreciated by 0.4% and 0.3% respectively.

Ringgit Performance Against Major Currencies



Ringgit Performance Against Regional Currencies



Performance of Ringgit Against Selected Currencies

RM per foreign currency	As at end				% change since*		
	21 Jul 05	2Q 07	1Q 08	2Q 08	21 Jul 05	2Q 07	1Q 08
US dollar	3.8000	3.4560	3.1875	3.2665	16.3	5.8	-2.4
Euro	4.6212	4.6105	5.0369	5.1565	-10.4	-10.6	-2.3
Pound sterling	6.6270	6.7867	6.3586	6.5114	1.8	4.2	-2.3
100 Japanese yen	3.3745	2.9339	3.1912	3.0749	9.7	-4.6	3.8
Singapore dollar	2.2570	2.2781	2.3102	2.3995	-5.9	-5.1	-3.7
100 Thai baht	9.0681	9.8785	10.107	9.7435	-6.9	1.4	3.7
100 Philippine peso	6.8131	7.1649	7.6421	7.2759	-6.4	-1.5	5.0
100 Indonesian rupiah	0.0386	0.0379	0.0346	0.0354	9.0	7.0	-2.3
100 Korean won	0.3665	0.3674	0.3211	0.3128	17.2	17.5	2.6
Chinese renminbi	0.4591	0.4471	0.4545	0.4764	-3.6	-6.2	-4.6

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

DEVELOPMENTS IN THE BANKING SECTOR

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

Banking system capitalisation level remained high

As at end-June 2008, the banking system remained well-capitalised with risk-weighted capital ratio (RWCR) and core capital ratio (CCR) of 13% and 10.1% respectively. During the quarter, capital base expanded by 2% due mainly to the issuance of non-cumulative preference shares and issuances of Ringgit denominated subordinated debt by two banking institutions. This partially offset the continued asset expansion of banking institutions and acquisition of subsidiaries. With excess capital of RM39.8 billion, the banking system remains in a strong position to continue supporting the financing needs of the economy.

	2007			2008	
	2Q	3Q	4Q	1Q	2Q
Capital					
CCR (%)	10.8	10.3	10.2	10.3	10.1
RWCR (%)	13.9	13.2	13.2	13.3	13.0

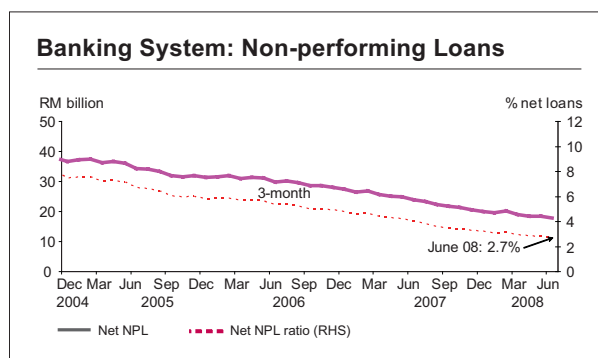
Continued profitability amid more challenging business environment

The banking system recorded a pre-tax profit (PBT) of RM5.2 billion during the quarter (1Q 08: RM 5.7 billion). This was supported

by sustained revenue from financing-related activities and wealth and portfolio management and remittance services. However, this was offset by lower net trading gains (-59%) due to trading losses of some investment and Islamic banks and marked-to-market losses on securities holdings. Accordingly, the annualised average returns on assets and equity stood at 1.7% (1Q 08: 1.8%) and 22% (1Q 08: 23.4%) respectively.

Level of non-performing loans continued to decline

Despite the more challenging environment, asset quality of the banking system improved further during the quarter. Net non-performing loans (NPL) based on 3-month classification declined by 6.7% to RM17.8 bil (1Q 08: RM19 billion) to account for 2.7% of total net loans (1Q 08: 3%). This trend has continued into July as non-performing loans declined to 2.5% of total net loans. This was attributed to continued recoveries and reclassifications of NPLs to performing status, as well as write-offs.



**The Fifth IFSB Summit:
“Globalisation of Islamic Finance Services - Opportunities and Challenges”
Amman, Jordan, 13 May 2008**

by

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

This decade has seen the financial globalisation of Islamic finance gain significant momentum. While the early development of Islamic finance was domestic centric, its internationalisation is now manifested by increased cross border flows, greater participation in international Islamic financial markets, the increased presence of Islamic financial institutions in new jurisdictions and more recently, the increased number of Islamic financial institutions which have shareholders from multiple jurisdictions. This trend has strengthened the international economic and financial interlinkages between nations bringing with it mutually reinforcing gains.

Financial globalisation has essentially been facilitated by the more rapid pace of liberalisation, the advancement in the information and communications technology, and the significant progress achieved in the development of the international financial infrastructure. This trend has also been reinforced by the search for higher returns and the need to diversify risks. In the current international financial environment of increased uncertainties, this trend has become even more pronounced prompting investors to venture into new asset classes and markets that provide stability.

The Globalisation of Islamic Financial Services

With the increased significance of the international dimension of Islamic finance, the financial landscape has been dramatically transformed with more diverse players and a more competitive environment. This in turn has been a catalyst for increased financial innovation and resulted in a wider range of

Islamic financial products and services. This has ignited interest from conventional global players from Non-Muslim countries largely in the form of increased participation in Islamic financial markets and in acquisition of strategic stakes in domestic Islamic financial institutions. With the opening of borders for banking institutions and other players, the Islamic financial system has become more diversified and the Islamic financial markets deepened. These developments have contributed to its rapid expansion across the globe, and Islamic finance has now emerged as among the fastest segments in the financial services industry.

The scope of Islamic finance business has thus expanded beyond retail and trade financing, to more sophisticated financial products in response to the changing global customer base. Such Shariah-compliant products include private equity, project finance, the origination and issuance of sukuk, as well as fund, asset and wealth management products. The sukuk market in particular, has become an important avenue for international fund raising and investment activities, has expanded by an annual growth rate of 40%. The vast potential in sukuk market in the international financial system indeed represents the crest of a new wave of innovation in Islamic finance and is very much part of the globalisation process in Islamic finance. Sukuk Musyarakah and Ijarah, which command the broader global acceptance, represents the majority of global sukuk issuances.

As part of the on going internationalisation of Islamic finance has been the development of the supporting international financial architecture. Of significance, is the establishment of the Islamic Financial

Services Board (IFSB) in 2002 to set the prudential standards for Islamic finance, and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) that was established in 1990. The importance of these international standard setting institutions has been their role in the harmonisation of prudential and accounting standards across the different jurisdictions. More importantly is their role in instituting international best practices in the global development of Islamic finance. It is these concerted efforts to develop robust international best practices in the prudential and supervisory framework that will ensure the resilience and long term sustainability of the Islamic financial industry.

With globalisation also comes enhanced interdependence. While the strengthened interlinkages can be expected to bring about a more efficient allocation of capital across borders which in turn would result in lower cost of capital, it has also resulted in the potential for the transfer of risks across different jurisdictions. This underscores the need to ensure the quality of financial globalisation. While the intrinsic nature of Islamic finance encourages risk management and provides confidence through explicit disclosure and transparency, the new risks resulting from globalisation needs to be taken into account. This is to ensure that the Islamic financial institutions have the capacity to manage the risks and that the regulatory authorities have the necessary instruments at its disposal to respond to any destabilising implications.

Emergence of new set of challenges

The enhanced international dimension of Islamic finance has thus brought about a new set of challenges. The emergence of more diverse Islamic financial institutions and the expanded development of Islamic financial markets have intensified the development of sophisticated Islamic banking, takaful and

capital market intermediaries. This has also resulted in the creation of sophisticated and complex structured financial instruments including hybrids of debt-equity structures. The increased competition has not only intensified the pace of innovation in products and services, but also of the operational processes and delivery channels. These developments have contributed to the **increasing complexity of the risks** profiles of Islamic financial transactions.

Global strategic initiatives

Recognizing the importance of ensuring financial resilience of the Islamic financial services industry in this more challenging environment, collaborative international efforts have been undertaken.

Spearheading the strategic development of the industry is the **ten-year Master Plan** for the development of the global Islamic financial industry, a joint initiative by the Islamic Development Bank (IDB) and the IFSB. This strategic initiative provides a blueprint for the orderly development of Islamic financial system across jurisdictions to achieve the common goal of a vibrant, efficient and progressive Islamic financial services industry. This blueprint also outlines the broad strategies for the development of the key components of the various parts of the Islamic financial sector, including the guide for determining the best options for the different stages of development of the Islamic financial system so as to ensure that it would contribute to the growth and development of the economy and also become an integral component of the international financial system.

Of importance is that the master plan not only represents a blueprint for the development of a cohesive and a comprehensive Islamic financial system but also it promotes increased

understanding and appreciation for those that wish to participate in the Islamic financial system, including providing information on the expected level of achievements that are required.

Another important global initiative in Islamic finance already mentioned is the promulgation of the **international prudential and supervisory standards** by the IFSB. The IFSB has fast-tracked the development of these standards to address the unique and peculiar characteristic of risks of Islamic financial contracts. Fundamental to the implementation of the standards is the strengthening of the risk management capabilities of the financial institutions. In addition, the implementation of these standards needs to be complemented by the continuous surveillance so as to ensure the early identification of the new emerging risks and to ensure that the institutions undertake to manage the risks.

Resilience reinforced by the intrinsic features of Islamic finance

The intrinsic features of Islamic finance also contribute to its overall resilience. This is derived from the Shariah principles, the key pillar of Islamic finance. The Shariah injunctions require that Islamic financial transactions be accompanied by an underlying productive activity resulting in a close link between financial and productive flows. Under the risk sharing concept, there is an explicit risk sharing by the financier and the customer. In this arrangement, the real activity is expected to generate sufficient wealth to compensate for the risks. Parties to the transactions would thus be insulated from excessive risks exposure given that the Shariah prohibits the excess leverage and involvement in speculative financial activities. The intrinsic principle of profit and risk sharing thus provides an in-built check and balance to the Islamic financial transactions. A combination of these distinct features together with the implementation of prudential risk management standards and

practices would contribute to the robustness and resilience of Islamic financial system.

Mutual respect on Shariah matters

This decade has thus been a phase of innovation in the global Islamic financial system with a number of breakthroughs and major milestones in innovative deals and structures. The advancement of sukuk, Islamic securitization, Islamic private equity, Islamic real estate investment fund and other financial instruments in terms of sophistication and product range has widened the international market reach of Islamic finance, particularly in the cross border transactions.

At the same time, this phase is also seeing a number of key issues being raised, particularly in respect of divergence of Shariah views underlying a number of the Islamic financial transactions. While such a divergence of opinions in Islamic financial transactions is not a new phenomenon, it has presented a new set of challenges in today's increasingly more globalized market. To forge closer linkages between the global Islamic financial markets would require a common understanding and acceptance on the applicable rules and standards. Indeed, cross border transactions would require the jurisdictions involved to **mutually recognise the validity of respective rules, practices and underlying Shariah interpretations**. This is key for the orderly development and for advancing the pace of progress of the international Islamic financial industry.

For this, it is important to have a concerted effort in providing greater clarity on the mutually acceptable strategy for the development of global Islamic finance. In the current globalised environment, the role of scholars needs to transcend beyond pure advisory or Shariah rule-making, to a more strategic role in charting industry development. This could be in part be achieved by having **global Shariah standards** for the Islamic

financial industry. A mutually agreeable position could be achieved with the application of **mutually recognized principles and processes to deduce the Shariah rulings and views**¹.

In relation to this, Malaysia has taken a **three-prong strategic initiative** to promote greater mutual respect of the Shariah views. The first is to recognise the principle of mutual respect in Shariah opinions issued in other jurisdictions by a recognized Shariah committee for transactions undertaken in Malaysia. In addition to the key role of a centralized Shariah Advisory Council as the reference point for all Shariah matters in Islamic finance, Malaysia welcomes Shariah rulings by other Shariah committees that are deemed to be **deduced through generally accepted rigorous principles, processes and rules**.

The second initiative is to have **strong resource foundation** supported by a pool of qualified and competent Shariah talent, as well as to accord more emphasis on extensive Shariah research in Islamic finance. Given the rapid global growth of Islamic finance, there is an urgent need to meet the talent demand for Shariah scholars with strong interest in the strategic development of the Islamic finance industry. From the supply side, the International Centre for Education in Islamic Finance (INCEIF) established in 2006 has made significant progress with more than 1000 registered students in its professional Islamic finance certification. It also has 28 PhD students and has recently launched a Masters Programme in Islamic finance. The Islamic Banking and Finance Institute Malaysia

(IBFIM) also offers a structured, modular training solutions for Shariah advisers focusing on practical and operational aspects of Islamic banking and takaful².

Given the importance of the in depth of Shariah research in Islamic finance, the International Shariah Research Academy (ISRA) was recently established as part of INCEIF to conduct applied Shariah research on the contemporary Islamic finance issues. The third strategy is to provide a platform that promotes active engagement and dialogue among the relevant stakeholders. The annual Shariah dialogue at international and regional levels have contributed to increased understanding of different views on Islamic finance matters and enhanced mutual respect of Shariah opinions.

Closing

In conclusion, against a backdrop of an increasingly uncertain global environment, Islamic financial system is indeed well positioned, as a form of financial intermediation in this more challenging environment. In the coming years, it is important for adequate focus to be given on the implementation of international prudential standards and sound risk management practices in Islamic financial institutions to ensure the financial stability and integrity of the financial system. According greater mutual respect to global Shariah views for Islamic finance would also contribute to the orderly global development of Islamic finance, thus sustaining the overall viability and soundness of the Islamic financial system as it becomes an integral part of the international financial system.

¹ There are lessons to be drawn from the previous success stories in the history of Islamic jurisprudence whereby the strong sense of mutual respect prevailed among Muslim jurists with multiplicity of Shariah opinions. The jurists from different mazhab had high regard for differing views expressed by other jurists, even in ibadah matters.

² IBFIM's "Shariah Scholars Induction Programme".

**The Mobile Digital Signature Symposium 2008:
“Towards a More Efficient Payment System - Electronic Payments”
Kuala Lumpur, 3 June 2008**

Keynote Address by

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

It is my honour and pleasure to be here today at this Mobile Digital Signature Symposium 2008 to deliver an address at this important forum. This forum takes place at a time when developments taking place in the global economy are resulting in fundamental changes to our lives. While the global economy has benefited from an extended period of high performance and strong growth, it now requires greater agility to adapt to the rapid changes that has occurred. A major emerging international phenomenon is the rising inflationary pressures.

We are now living in an environment characterised by rising prices, with energy and commodity prices prevailing at record highs. Energy and commodity prices which have risen steeply have been driven by demand and supply factors and reinforced by market conditions. Clearly, the global factors that have influenced these international prices are beyond our control. Individually and collectively, we therefore need to adjust and adapt to these new conditions. Increasing efficiency and adopting new business processes needs to be explored to reduce costs.

An area in which the quantum leap forward can be made, particularly by emerging economies, that will substantially increase the level of efficiency and thus reduce costs, is through the adoption of a more expedient and efficient means of payment. This will be the subject of my remarks today. While the Central Bank supplies currency notes and coins, we are also concerned with payments in its broader context. An important function and responsibility of the Central Bank is to promote the development of safe and efficient payment systems. Any inability to make payments in an economy would have a far reaching and widespread impact on

society. Our task is therefore to ensure that the public and businesses can make payments in a safe and efficient manner.

The task also involves taking advantage of the technology and innovation wave and to move towards more efficient payment modes. The economic benefits from this can be immense. Studies have shown that shifting from paper based to a more electronic based payment systems can generate an annual savings up to 1% of GDP. Further research has also shown that it becomes a catalyst that promotes increased consumption spending. Moreover, it can also enhance financial inclusion by extending financial services to the unbanked communities. In so doing, such communities would be brought into the formal financial system and into the economic mainstream. This would not only promote the opening of banking accounts amongst this target group but would also enable them to enjoy lower cost of financial services and better means of savings, thus benefiting the economy as a whole. As the electronic payment channels become more easily accessible, user-friendly and offered at a low cost, it would thus provide the opportunity to shift the remittance flows from the informal to formal channels.

Indeed, electronic payments can be one of the strategic tools to meet these objectives and achieve higher economic growth. Electronic payment increases operational efficiency and improves productivity levels through expedient payments and receipts of funds. Electronic payments would also provide the speed and convenience of making payments from any place or time. It also reduces costs through the reduction or redeployment of resources used for handling cash and cheques. Accelerating the

country's migration to electronic payments has therefore become a part of Malaysia's larger national agenda to increase the efficiency of the nation's payment systems which would ultimately improve the competitiveness of our economy.

Cash payments in Malaysia still account for a large portion of the number of transactions in the economy. Going forward it is expected that its use will level off and stabilise with the increased use of electronic means of payments. Credit cards, ATM cards, debit cards including the e-purse application embedded in the MyKad are among the card payments possibilities in Malaysia. The increased use of cards is an international trend and is expected to gain significance in Malaysia. Giro transfers, other credit transfers and direct debit are also gaining significance by both individuals and businesses. Finally, Internet banking has also begun to experience stronger growth.

While we have made considerable progress in promoting the adoption of electronic payment with notable growth registered across all electronic payment methods, paper-based payments still remains the more popular form of payment. Cheques continue to account for a high percentage of the total non-cash retail payments while currency-in-circulation (CIC) as a percentage of GDP remains relatively high at 5.7%. In 2006, Malaysian consumers on average, made only 0.7 transaction via direct debit and credit transfer and 0.2 transaction via debit card transaction as compared to 84.7 and 109.5 transactions, respectively, in Sweden. Hence, more needs to be done to raise the level of adoption of electronic payments.

In this regard, the Bank has formulated an Electronic Payments Roadmap aimed at bringing together relevant stakeholders to address the barriers that have impeded the increased adoption of electronic payment in a comprehensive and strategic manner. The Roadmap identifies the priority areas that require attention and collaboration to promote an environment that is conducive for greater use of electronic payment in financial transactions.

Firstly, is the need to put in place the payment infrastructure. The infrastructure for making payments would need to be widened and enhanced to provide the convenient access to electronic payments. In addition, solutions need to be developed to enable users to integrate easily with the payment offerings. Secondly, the product range, the range of services would need to be expanded to cater for the different payment needs of consumers and business sectors. Thirdly, the pricing framework, the formulation of a transparent and cost-effective pricing framework is important to provide the incentive structure that would spur the adoption of electronic means of payments. Fourth, is the consumer awareness. Programmes need to be implemented to inculcate the behavioral change among consumers. There needs to be trust and confidence in the electronic payment systems. The fifth area relates to the standards, the setting of common standards to address the interoperability of systems including standardising the payment messaging format is vital to the wider acceptance of electronic payment. Finally, is the need to ensure the security and integrity of the payment system which thus requires the supporting regulatory and legal framework to be in place.

Among the series of initiatives that have been implemented to promote the greater use of electronic payment relates to the leadership role of the Government in the migration to electronic means of payment. As most individuals and businesses have payment transactions with the Government, the role of the Government in accepting electronic payments has provided an important catalyst for the adoption of electronic payment on a national scale. In this regard, Bank Negara Malaysia has been in active partnership with the Government to drive the electronic payment agenda. This has also served to reinforce the Government's objective to enhance the efficiency of the public delivery system. This collaboration has resulted in the acceptance of the use of cards including the ATM card, which also functions as a debit card, for over the counter services and the offering of payment services via Internet banking and the Internet-based Financial Process Exchange (FPX) payment system.

Another initiative undertaken has been the review of the remittance and e-money regulatory framework to encourage the introduction of payment products that would cater for the unbanked and underserved communities such as migrant workers and consumers with low income and low financial literacy and who may have no alternative but to rely on informal payment service providers. There are now more than 20 new remittance and mobile payment products that have been launched.

The Bank has already engaged the relevant stakeholders on the priority areas identified and welcomes any further industry efforts to address these issues. Given the significant pay-offs from the use of low cost technologies in accelerating the adoption of electronic payment, the mobile phone is identified as one of the delivery channels that should be leveraged on.

Potential of mobile phones to make the transformation

Bank Negara Malaysia sees tremendous promise in mobile telecommunication networks as an electronic payment channel since mobile phones are already in the hands of most Malaysians, with 88% of the Malaysian population subscribing to mobile phone services.

The high penetration rate affirms mobile phone networks as an increasingly popular channel for Malaysians to perform a plethora of activities beyond voice communication, encompassing all forms of digital communication, commerce, banking and payments. Indeed, payments via text messaging has the potential to grow in importance.

With 25 million mobile phone subscribers in Malaysia, there are immense opportunities to leverage on mobile phones to accelerate the migration to electronic payments, to widen the reach and appeal of electronic payment services, to deliver innovative mobile payment products that offer speed, simplicity and convenience at minimal cost for the public, as well as to provide an efficient and cost-effective method of delivering financial services even

in the remote areas. Also of significance is the high level of financial inclusion in Malaysia. With a population of 27 million, the banking system in Malaysia has 55 million deposit accounts indicating that a high percentage of the population have deposit accounts with the banking system. This is confirmed by a survey of a sample of 5,000 in 2003 that indicated 97% of those surveyed have a bank account. The financialisation of savings is also confirmed by the high percentage of deposits to GDP at 152%.

The high percentage of mobile phone subscriber and the high rate of participation of the population in the banking system are important pre-conditions for the significant use of the mobile phone as an ideal platform for personal payments. Indeed, the large mobile subscriber base and the positive transformational effects of mobile banking and payments offer a unique opportunity to open up the financial system to more customers and communities, in order to achieve financial inclusion for all segments of our society.

With the favourable market conditions, various mobile banking and payment initiatives have been launched in recent years. This however, has yet to achieve widespread acceptance. To date, there are only 460,000 subscribers for mobile banking and payment services. This represents only 1.8% of the 25 million mobile phone subscribers in the country. There is, therefore, a significant untapped, and potentially lucrative market for mobile payment and banking services.

Pushing mobile channel beyond the tipping point of development

There are fundamental issues that need to be addressed if we are to realise the opportunities and allow Malaysia to take full advantage of new mobile technologies. To achieve their full potential, it is important to identify the gaps in the service offerings, and plan the way ahead for Malaysia to make the quantum leap in e-payment adoption. Market participants need to address the mismatch between what consumers expect and what is being offered. Openness and inter-connectivity are also critical

in the mobile banking and payment initiatives. Exclusive and proprietary services where the target market is limited to the customer base of individual mobile operators or individual banks will not allow for the potential to be realised. Any lack of interoperability across mobile operators and across banks will not achieve the required critical mass and will also result in high transaction cost for consumers.

It is hoped that market participants will be able to offer new and innovative mobile payment products and services that opens up new markets for mobile service providers and payment operators, offer the convenience at reasonable costs and thus deliver the cost savings and efficiency gains that consumers and businesses seek, and thus allow for the economic benefits to be realised.

Industry players also need to work together. An area that needs critical attention is for the industry players to focus on the bigger picture and regard the mobile phone as a mechanism towards achieving a common goal. To promote the significant use of the mobile phone for financial services, the industry has to respond rapidly to address the need for interoperability and collaborate in areas such as developing a common infrastructure, common payment messaging format, as well as common security and authentication standards. Common standards and infrastructure will create an accessible, open and vibrant payment eco-system that will attract a wider consumer base allowing all market participants to reap the benefits of a larger customer base. A shared integrated network with common security standards and common messaging standards will make it easier, more cost-effective, and more convenient for consumers, merchants and service providers to execute and receive payments, thereby increasing the attractiveness of the mobile network as a payment channel. Such collaboration will also lead to greater innovation and increased productivity that will contribute to the overall effectiveness and performance of the mobile payment system.

In delivering products that the market demands, substantial investments would be required of participants in the mobile eco-system: the mobile operators, banking institutions, mobile device manufacturers, and payment service providers. Equally important therefore, is the need for all the stakeholders to ensure that investments are channeled judiciously into the areas of greatest impact. Strengthened collaboration in the key areas will minimise duplication and achieve greater resource efficiency. In this regard, there is a need to fully understand customer payment preferences. Product offerings need to meet the expectations of increasingly discerning and sophisticated consumers of payment services. Collaboration is also required in the area of education and outreach programmes to increase consumer awareness and public confidence in mobile payments.

Thirdly, regulators and market players must also share a common vision on the future mobile payment landscape in order to align strategies and interests to achieve holistic mobile payment solutions that will widen access to the retail payment system and thus achieve a critical mass of consumers. The network externalities and the social benefits of the wide adoption of the mobile banking and payment system provides justification for Governmental intervention. The Bank together with Malaysian Communications and Multimedia Commission will work towards providing the appropriate environment for economic development and to catalyse the transformation of the mobile initiatives. This will also include engagement with the market participants, payment service providers and industry players to collaborate in these important areas.

Finally, for mobile payment products to succeed and achieve widespread acceptance, we need to strengthen consumer confidence in the safety, security and reliability of mobile networks as a means for consumers to access financial services. Indeed, mobile digital signature, which ensures the confidentiality, authenticity

and integrity of payments initiated from mobile phones, is one of the ways forward towards building a secure mobile infrastructure that is conducive for the delivery of financial services.

Conclusion

We are now operating in an environment where we have to do more with less. The point I would like to stress this morning is that in the pursuit of this cause, we have to learn to work together. We need to come together to

decide how this cooperation can be shaped. I believe this symposium will contribute towards achieving this objective. In this regard, I hope that the results of your deliberations in this symposium will provide valuable input for the formulation of strategies and modalities for both the industry and authorities. On that note, I would like to thank Malaysian Communications and Multimedia Commission for this opportunity to share my thoughts on electronic payments. I wish you a stimulating and productive discussion in this symposium.

**The 12th Malaysian Banking Summit organised by ASLI:
“Taking the Leap in Paradigm Shift of Banking - New Wave, New Ventures”
Kuala Lumpur, 5 June 2008**

Keynote Address by

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

In this recent decade we have seen a period of profound modernisation of the Malaysian banking sector. Today, the banking sector has evolved from facilitating and supporting the economic growth process to becoming a significant source of growth. Innovation and product pioneering has proliferated the diversity of products and services offered. The adoption of best business practices, the use of new technologies, systematic cross selling and the new means of interface with consumers have become more pervasive. The banking system is also significantly stronger, reinforced by strengthened institutional structures, enhanced financial safety nets and developed financial markets, that includes one of the most developed bond markets in this region. Progressive deregulation and liberalisation have increased the flexibilities for banking institutions to capitalise on new business opportunities, both onshore and overseas. The strengthened incentives and more competitive environment have also prompted continuous performance improvements. Indeed, these developments have well positioned the banking sector to take the next leap forward.

It is my pleasure to be here this morning to speak at this year’s Malaysian Banking Summit which has focussed on the theme, the next wave for the banking system in Malaysia. My remarks today will focus on three areas - firstly, the outlook for the Malaysian economy as developments continue to unfold in the domestic and international economic environment. Secondly, I will discuss some of the key lessons that may be drawn from the recent credit turmoil and their implications for the Malaysian banking system. And finally, I will take the opportunity to share with you some thoughts on our vision for the financial

sector beyond our current Financial Sector Master Plan and the thrust of our strategies going forward.

The Malaysian economy enters this more challenging period following several consecutive years of solid growth that averaged 6%. The economy grew by 6.3% in 2007, the fastest pace in three years with the growth momentum being sustained in the first half of 2008. In the first quarter of this year, the economy expanded by 7.1%.

This stronger growth was achieved despite the more difficult environment with slower global growth and increased uncertainties in the international financial markets. The successful transformation of the Malaysian economy in this recent decade has been one of the important contributing factors. It has led to more diversified sources of growth resulting in a more balanced economy. While the external sector remains important, domestic demand now has a more significant role in driving the growth process. In addition, the services sector has become a more important source of growth. Moreover, the agriculture sector continues to expand as Malaysia benefits from the high commodities prices. These developments have continued to sustain our external balance with the current account of the balance of payments likely to continue to record large surpluses.

Going forward, in the next 12 to 18 months, several external and domestic developments need to be taken into account in the assessment of our economic outlook. First, the slowdown experienced in a number of the major economies is likely to extend into 2009. This more prolonged period of slowdown

is likely to have spill over effects on other economies including emerging economies. Global financial markets are also expected to remain volatile as the financial stress experienced by financial institutions in these economies continue to have an impact on credit conditions, the housing market and their overall economy. These developments have resulted in a number of institutions scaling back their global operations. The disruptions in the credit markets have already exerted some restraint in economic activity. While the adjustments are still taking place, there remains uncertainty about the full magnitude of the losses and its consequent impact on financial stability and thus on their overall economy.

Despite these developments, indications are that growth remains resilient here in the Asian region, benefiting from the strengthened domestic demand and the increased trade activity within the region and with the non-traditional markets. The region however, still remains highly integrated to the global economy and international financial system and therefore will have to manage the risk of moderation in global growth in the event that a more pronounced slowdown occurs in the major developed economies.

This risk is compounded by the high and rising energy and commodity prices, which are impacting inflation in most countries today. Stronger demand for grains, the diversion of land used for food crops to biofuel crops, the higher transportation costs and adverse weather conditions are some of the factors driving the rise in food prices. As a consequence, rising cost pressures on inflation in the global economy can be expected to persist. Should global growth however, continue to moderate in the second-half of 2008, this can be expected to slow the pace of increase in energy and food prices, which in turn, will moderate the inflationary pressures that are currently being felt.

Several domestic factors have sustained the growth of the Malaysian economy indicating

that external demand has thus far resulted in only a modest moderation in our overall growth as the underlying strength of the economy has been able to sustain the resilience of the growth process. This has been underpinned by the strong domestic demand which has become a key driver of growth. The strong growth that has been achieved so far is on account of the robust expansion in private consumption and investment expenditure.

Malaysia's economic structure has also become increasingly more diversified with increased contribution to growth from the services, agriculture and commodities sectors and the resource-based and knowledge-driven industries. Malaysia is also very much part of the regional integration that is taking place. Today, about 63% of our exports are to the countries in the Asian region. Efforts are also being put into forging stronger trade linkages with other non-traditional markets in West Asia and the Middle East and these efforts are now showing positive results. The trade links are also reinforced by increased investment flows within and between these regions. The inflow of foreign direct investment into Malaysia has remained steady while Malaysia's investments abroad, in particular, to this region are increasing.

Finally, an important factor supporting the resilience of the economy in this more challenging time is the sound macroeconomic fundamentals, the high international reserves and the capacity for policy stimulus to be undertaken to manage the risks to growth. The economy is also supported by the favourable financing conditions and strengthened banking system. Ample liquidity amidst a relatively low interest rate environment and declining non-performing loans have sustained private sector access to financing.

The urgent issue that may be raised today is to what extent will the price adjustments announced yesterday have an impact on the economy. Related to this is the extent to which inflation will increase and whether this would in turn affect the country's competitiveness.

Key to dealing with these risks is the flexibility of the Malaysian economy. Malaysia has a proven track record over several decades in successfully dealing with difficult periods in our economic history. Each time, the flexibility of the economy, the agility of the private sector to adjust and reinforcement by the policy response, has allowed the economy to emerge stronger. This was demonstrated during the Asian crisis. Within a period of one year, our economy was able to resume growth, expanding by 6.1% in 1999 and by 8.9% in 2000.

The current conditions are by no means of such threatening proportions. If managed well by all parts of the economy, the economy will in fact emerge more competitive and stronger. This will require concerted efforts by the private and public sectors to become more efficient and thus reduce costs. This will also require shifting resources to new areas of activities where Malaysia has the competitive advantage. With the aptitude for hard work and prudent practices, and the ability for reinvention, this can be realised. To a great extent this has been achieved in the financial sector which has now emerged as an economic sector that generates income and employment and accounts for 11% of the economy, from only 4.5% in 1990.

The current increasing inflationary pressures is a global phenomenon, the result of rising international prices of energy and commodities prices. In Malaysia, domestic inflation has increased from less than 1% in April 2004 to 3% in April 2008, primarily reflecting higher food and energy prices. The Bank's preliminary assessment of the impact of the rationalisation of the domestic fuel and energy prices on inflation in 2008, is that it will rise to an average of 4.2% for the year. The initial price impact would be felt in June during which inflation is expected to be in the region of 5%. The increases in prices are expected to peak in the first quarter of 2009 before moderating to less than 3% in the fourth quarter.

As international prices of commodities are expected to continue to remain high and as direct influence over these prices is limited,

efforts will have to be focussed on increasing efficiency and productivity to reduce cost and to shift resources to areas of comparative advantage. From the perspective of monetary policy, the concern would be on the potential second-round impact of these price increases, the extent to which they lead to more generalised price increases and whether they pose a serious risk to inflationary expectations.

It must be remembered that the current inflationary pressures is a global phenomenon, and that many of our trading partners and neighbours are having similar or higher inflation rates. Given this fact, the increase in inflation is unlikely to erode Malaysia's comparative advantages in global trade.

The experience during current international financial turmoil have demonstrated fragilities in financial systems even among the developed economies. These events have brought to the forefront key issues regarding financial intermediation, financial innovation and the corresponding regulatory and surveillance mechanisms that need to be put in place to provide the necessary oversight over such activities. Although our domestic financial system was not impacted by the sub-prime crisis, its underlying causes bear important lessons for Malaysia, and indeed, for other emerging economies, as the forces of globalisation continue to drive the modernisation of our financial systems.

Firstly, the combination of a misaligned incentive system, a favourable macroeconomic environment and heightened competition generated excessive risk-taking by financial institutions. Under these circumstances which prevailed prior to the current crisis, financial innovation occurred at a pace that outstripped the capacity of the financial system to manage the risks associated with such innovations. Indeed, one of the fundamental underlying weaknesses was the erosion of sound practices in the mortgage market segment, with banks compromising on sound underwriting standards and risk management practices in pursuit of short term gains and market share. While the banking institutions

had increasingly employed sophisticated financial engineering techniques to repackage mortgages into complex structured securities, such financial innovation was not supported by commensurate enhancements to governance processes and the risk management infrastructure and practices. This resulted in a significant underestimation of the risks being borne by the financial institutions and to an overestimation of the capital buffers in the financial system.

Secondly, the events of the financial and credit market crisis have re-focused attention and debate on the susceptibility of the financial system to market failures. Indeed, the crisis unraveled significant gaps in the extent and manner of public disclosures that were made by financial institutions regarding their on- and off-balance sheet risk exposures. Investors on the other hand, were over-reliant on credit ratings which were based on methodologies which were not sufficiently robust, or lacked transparency about the rating parameters. As a result, the effects of market discipline did not occur as expected, while regulators which relied on market discipline to take effect, did not act pre-emptively to add discipline where it was needed.

Thirdly, developments in the regulatory, accounting and macro-surveillance frameworks had not anticipated, nor provided for, the complex inter-linkages of the modern financial system. The most significant evidence of this was when large scale downward valuations of assets due to accounting rules which heightened risk aversion, which in turn further constricted market liquidity, thereby perpetuating a vicious cycle. Globally, episodes of financial crisis have again demonstrated that market, credit and operational risks are closely inter-linked.

These experiences have underscored the critical importance of good governance, sound risk management, rigorous supervision and a strengthened crisis management framework which is sufficiently robust to withstand extreme market conditions.

The Malaysian banking sector on the whole is sound. Domestic banking institutions, in particular, have benefited from the broad-based reforms and capacity building measures that had been undertaken following the Asian financial crisis. Notably, the consolidation of the banking sector, the strengthened board and senior management oversight functions within banks, and the more risk-sensitive capital and the stress-testing requirements have contributed towards reinforcing the core foundations for a more resilient banking system. Banking institutions have also made significant advances in the adoption of improved risk management infrastructure and practices.

Today, the payoffs from these efforts are evident. The banking sector has maintained a steady growth momentum since the Asian financial crisis, with profitability of the Malaysian banking system growing by 36.7% to record RM17.7 billion in 2007. The exposure of the Malaysian banking sector to the sub-prime market has been minimal amounting to only 0.3% of the capital base of the banking sector.

The Malaysian banking institutions are thus now on a stronger foundation to venture into new businesses, undertake more complex risks and withstand shocks. Their enhanced capabilities are backed by stronger balance sheets, with the risk-weighted capital ratio of the banking sector at 13.2% and net non-performing loans ratio of 3.0%.

On the regulatory front, Bank Negara Malaysia continues to direct significant effort and resources towards strengthening our surveillance capabilities to detect, monitor and to deal pre-emptively with emerging risks and vulnerabilities in the financial system. These efforts have also been reinforced by improvements in the surveillance tools and processes to enable pre-emptive action to be taken to avoid disruptions to the financial system. The supervisory processes have also been enhanced with more granular and holistic risk assessments of the financial institutions.

In terms of the regulatory framework, the Bank will be outlining the approach for the implementation of Pillar 2 of the Basel II Framework. The Bank is providing further guidance in the areas of liquidity and operational risk management, the maintenance of internal capital targets, market disclosures, and the valuation processes and controls - particularly for illiquid instruments. The guidance will also be issued to address the implementation of the internal capital adequacy assessment process within the institutions to complement the minimum regulatory standards under Pillar 1 and will also stipulate the minimum requirements for banks that are adopting the Internal Ratings-Based Approach. Details of the proposed capital framework for securitization will also be released during the year. In addition, the liquidity guidelines will be revised to strengthen the requirements in the management of foreign currency cash flow mismatches over different time horizons.

Corporate governance will remain an important priority of the regulatory framework in preserving a sound financial system. The progressive adoption of more principle-based regulations has placed greater reliance on the effective oversight by boards and the senior management to ensure that the regulatory flexibilities accorded to financial institutions are exercised in a judicious manner. A revised fit and proper standard for directors, senior management and controllers of financial institutions will be issued, complemented by an improved and coordinated strategy for the education of directors of financial institutions to strengthen their oversight responsibilities in a more complex financial landscape.

The recent crisis also brought to light the critical importance of coordinated and prompt response by regulators in dealing with crises, whether through market interventions or in the resolution of banking institutions that are experiencing difficulty. Coordinated actions by the Central Banks in Europe and the United States have relieved the liquidity tensions in the financial markets. However, national arrangements for dealing with problem banking institutions are being severely tested.

Decisive action is vital to ensure the continued intermediation process to stem the spread of the financial crisis within the financial system and to the real sector. Such early action will also reduce the cost of the crisis. For Malaysia the cost of the crisis ten years ago was less than 5% of GDP. Danamodal in fact recorded a pre-tax profit of RM200 million upon full repayment from the recapitalised institutions.

More recently, additional initiatives have been taken to strengthen the safety net, inter-agency coordination arrangements and the legal framework for interventions. Today, we have a holistic financial safety net framework in Malaysia which includes a lender of last resort framework and a comprehensive deposit insurance system. The regulatory and supervisory framework is also supported by enhanced intervention framework for dealing with banks under financial stress. The enhanced supervisory intervention powers is to be embodied in the amendments to the various legislations administered by the Central Bank.

The provision of liquidity support by Bank Negara Malaysia for financial institutions in distress is a key component of the safety net. In light of recent international experiences of bank failures, the traditional intervention criterion of lending to 'solvent but illiquid' banks has been put to the test as it becomes increasingly difficult to determine the necessity for intervention as well as the method and timing of such measures. The extension of such support will therefore be based on a careful balance of various considerations, which include amongst others, its potential systemic implications, the cost of the intervention, the cost of failures, avoiding disruptions in the functioning of markets and finally its potential social implications. In order to avoid long term moral hazard, the lender of last resort is based on the rigorous application of viability tests and the 'first loss principle', where losses are borne by the shareholders of the financial institutions. The operational framework also needs sufficient flexibility, in terms of policy instruments, acceptable collateral and range of counterparties, to deal with exceptional market conditions.

Going forward, cooperation arrangements for dealing with crises will continue to be further enhanced. This includes further strengthening current cooperation arrangements among the various regulatory agencies in Malaysia, as well further advancing cross-border cooperation in the region. Indeed, significant strides have already been taken to strengthen the cooperative framework between central banks and supervisory agencies in the region to promote financial stability at the regional level. These have included the establishment of various regional mechanisms for cooperation and coordination in surveillance, information sharing and crisis management. These mechanisms will become increasingly important as regional integration continues to deepen and as more Malaysian financial institutions venture overseas.

The progress that has been achieved in the financial sector has surpassed the initial expectations outlined in the Financial Sector Master Plan. The foundation of a vibrant, sound, stable and resilient financial sector accords the opportunity of advancing the sector to a new level where new opportunities with new formulas and strategies for success can be achieved. The financial sector has been key in supporting the transformation of the Malaysian economy, to increase its significance and to promote a more diversified economic structure. This has been achieved by the increased financing extended via the banking system and capital market. In particular, outstanding loans and private debt securities expanded by an average of 7.8% for the period 2001-2007. Malaysia is also ranked third in terms of access to credit amongst 175 countries surveyed by the World Bank in the Doing Business Report 2007. In an environment of rising incomes and expanding domestic demand, the further modernization of retail banking will be important going forward. With increasing financial literacy and growing consumer sophistication, product pioneering and cross-selling, the trend towards electronic financial transactions will gain significance.

Increasingly, loans to the corporate sector will become less dominant with an expanding and efficient functioning capital market.

In particular, the bond market presents opportunities for increased corporate advisory and debt and equity underwriting business. Private debt securities now represent 45.5% of GDP. An increasing trend that will become even more important in the future are the SMEs. By 2010, it is expected that SMEs contribution to the economy will be 37%, and account for 22% of exports. Loans approved by the banking institutions and development financial institutions to SMEs have increased by 34.3% to RM63.2 billion in 2007. This trend is expected to accelerate in the future. Microfinancing is also important for micro-enterprises to accord to greater financial services and hence contribute towards balanced growth.

In the recent three years, the finance and insurance sector expanded by 8.3% per annum, outpacing the growth in real GDP of about 6%. The financial sector now accounts for 11.0% of GDP, with about 140,000 people employed in the industry. Reflecting the higher skilled positions in the industry, the average salary in the industry is 2.4 times the country's per capita income and is amongst the highest in the economy. The financial sector's high demand for skilled talent thus require significant investment.

As part of the strategic positioning of Malaysia to attain a developed economy status in 2020, the financial sector moving forward also has an important role as a catalyst of economic growth. Studies have shown that banks play an important role in promoting the creation of new industries as well as in generating spillover effects on other sectors of the economy. In developing the financial sector, it contributes substantially to the growth of the professional services sector, that includes the network of supporting services encompassing software development, telecommunications, shared services, and legal and accounting services. Often, the ability of the financial sector to play this catalyst role depends on the sector having sufficient critical mass. Such a financial sector is able to play an important role in mobilising talent and business linkages to strengthen research and development efforts and spur innovation in other economic sectors. Through

the channeling of productivity, the financial sector can drive endogenous growth in other economic sectors.

Let me turn to two areas where Malaysia has strong competitive advantage. The first is in Islamic finance and the second is shared services and outsourcing (SSO). Malaysia is at the forefront in the development of Islamic finance, housing the world's largest sukuk market with 65.8% of the global outstanding sukuk as at end-March 2008. Building on our established foundation in Islamic finance in terms of experience, infrastructure and knowledge, the promotion of Malaysia as an international Islamic financial hub is expected to catalyse growth in other economic sectors. Positive effects are expected to spill over to the markets and related industries such as the property market and health, education and business services sectors, spreading the sector's growth momentum to the economy.

Similarly, there exists potential for a greater mutually reinforcing relationship between the financial sector and the SSO industry in Malaysia. The financial sector's participation in the SSO sector is expected to provide the impetus for growth in the information communication technology industry as more technology-driven hubs are established in Malaysia. Indeed, Malaysia is ranked as the third most attractive outsourcing centre globally, already housing 123 SSO centres which include leaders in the finance, technology and energy industries.

The liberalisation plan moving forward aims to reinforce the role of the Malaysian financial sector in the next phase of development, capitalising on core comparative advantages whilst reaping benefits from alliances and partnerships. The strategy will focus on the strategic positioning of the Malaysian financial sector, with differentiated strategies tailored towards different sub-sectors and markets. Malaysia will pursue more aggressive liberalisation strategies to maximise our potential in areas where there will be mutual benefits from such greater liberalisation. An

area that will be pursued is increased strategic alliances with foreign partners and greater foreign participation in our financial markets. This will be key to enhancing our economic and financial interlinkages with other parts of the world.

In particular, initial advancements to support the ongoing efforts on integration with the other South East Asian nations through the ASEAN Economic Community (AEC) will facilitate broader and deeper economic cooperation in the region. It is evident from the recent ventures abroad by Malaysian banking institutions, that the prospects in the region are recognised. There is tremendous potential for Malaysian banks to reap greater benefits from increased regional integration through diversification of income streams and the fast-growing prosperity of the region. Such expansion however, needs to commensurate with the institutional capacity. On reciprocal grounds, consideration will be granted towards enhancing the presence of ASEAN-origin financial institutions in Malaysia. Indeed, liberalisation including greater market access may be granted to countries where there are also reciprocal potential for Malaysian financial institutions to promote greater economic and financial integration in the region.

The operating landscape moving forward is going to be increasingly challenging. Competitive pressures and global developments will continue to shape the transformation process of the financial sector. While the growth prospects of the financial sector remain positive, with the financial sector having emerged stronger and more effective, it also has the prospects of staying ahead of the curve, break new grounds in the development and quality of banking services and delivery channels. The ability to compete will drive performance and innovation within the financial sector, raising the potential to contribute to the economy to make the leap towards realizing Vision 2020. There is a high degree of confidence that the Malaysian financial sector will rise to the challenge.

CALENDAR OF EVENTS April - Jun 2008

1 April 2008

The Rounding Mechanism to the nearest 5 sen for over-the-counter payments was fully implemented. Announced by the Bank in November 2007, the implementation of the Rounding Mechanism benefits consumers by making more convenient and faster payments while resulting in savings on handling costs for businesses. The 1 sen coin will remain a legal tender.

In a separate announcement on 14 April, the Bank's Shariah Advisory Council decided at its 74th meeting that the Rounding Mechanism is Shariah-compliant, based on the fact that the implementation is for public interest.

8 April 2008

The Bank announced the introduction of the Cheque Truncation and Conversion System (CTCS) to replace the current physical cheque clearing system with the objective of achieving faster clearing time for all cheques. The cheque truncation involves the clearing of cheques based on their image and magnetic ink character recognition (MICR) code data which would then be transmitted electronically. Subsequently, in the cheque conversion process, the clearing would be based solely on the MICR code which is then converted into a payment instruction. The implementation of CTCS will commence in May 2008 within Klang Valley area and it will be adopted on a nationwide basis by 2009. The new system will enhance the efficiency of the payout structure for both consumers and businesses and may even boost economic growth. The implementation of CTCS reflects the Bank's continuous effort to promote e-payment system for transactions.

29 April 2008

At its third meeting for 2008, the Bank's Monetary Policy Committee (MPC) decided to leave the Overnight Policy Rate (OPR) unchanged at 3.50%. The Monetary Policy Statement revealed that the latest available data from the major industrial economies indicate a moderation of economic activity in these countries. This is likely to lead to slower global growth in the months ahead. Subsequently at its meeting on 26 May, the MPC maintained OPR at 3.50%. The MPC noted that although the domestic economy performed well in the first quarter of 2008, there is clearer evidence of the slowing growth in the major economies. This moderation in growth is expected to be felt by the regional economies, including Malaysia, during the second half of the year.

The MPC views the latest data on key international and domestic economic variables as being supportive of its assessment that going forward, the risks to inflation are on the upside, while the risks to growth are on the downside. The MPS added that future thrust of monetary policy will depend on further information on the relative dominance of either risk going forward.

13 May 2008

Governor Dr. Zeti delivered a speech on "Globalisation of Islamic Finance Services - Opportunities and Challenges" at the Malaysia Country Showcase in Amman, Jordan, held in conjunction with the 5th Islamic Financial Services Board (IFSB) Summit. She highlighted that Islamic financial system is well positioned as a form of financial intermediation under increasingly uncertain global environment. She noted, however that adequate focus needs to be given on the implementation of international prudential standards and sound risk management practices in Islamic financial institutions to ensure

the financial stability and integrity of the financial system. Governor also pointed out that according greater mutual respect to global Shariah views for Islamic finance would also contribute to sustaining the overall viability and soundness of the Islamic financial system.

28 May 2008

The Bank announced that Malaysia's GDP grew by 7.1% on an annual basis in the first quarter of 2008. The strong growth was driven by double-digit expansion in private and public consumption spending. This was further supported by strong external demand, strong export growth and moderating imports. Headline inflation for the period increased slightly to 2.6% from 2.2% in the previous quarter, due mainly to the rise in prices of food, and to a lesser extent in miscellaneous goods and services. The 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.

On the same day, the Bank announced further liberalisation of the foreign exchange administration rules on borrowing in foreign currency by residents as well as borrowing and lending in ringgit between residents and non-residents. This liberalisation is part of the Bank's continuous efforts to enhance Malaysia's competitiveness by facilitating greater access to financing and reducing the cost of doing business.

31 May 2008

The Bank issued a set of commemorative coins to commemorate the 50th Anniversary of the establishment of the Royal Malaysian Air Force (RMAF). Later, on 24 Jun, the Bank issued a set of commemorative coins to mark the centennial of the establishment of St. John Ambulance of Malaysia (SJAM). Both sets are available in three specifications; Gold Commemorative Coin (proof), Silver Commemorative Coin (proof) and Nordic Gold Brilliant Uncirculated (B.U) Commemorative Coin.

2 June 2008

The Bank, as the Secretariat of the National SME Development Council (NSDC), hosted the eighth NSDC meeting where several key initiatives were endorsed to promote a more competitive and resilient small and medium enterprise (SME) sector. Among others, the Council agreed to set up a Special Committee headed by the Governor of Bank Negara Malaysia to recommend measures to help SMEs cope with rising inflation due to higher oil prices and costs. Measures to be considered include measures to encourage SMEs to upgrade their machineries and equipment, as well as to enhance SME awareness and understanding on existing development programmes and financial assistance schemes made available for the sector.

3 June 2008

At the Mobile Digital Signature 2008 Symposium, Governor delivered a keynote address on "Towards a More Efficient Payment System: Electronic Payments". She highlighted that by adopting a more expedient and efficient means of payment, it will substantially increase the level of business efficiency and thus reduce costs. Governor highlighted that studies have shown that shifting from paper based to electronic based payment systems can generate an annual savings up to 1% of GDP. Bank Negara Malaysia has formulated an Electronic Payments Roadmap aimed at identifying the priority areas that require attention and collaboration to promote an environment that is conducive for greater use of electronic payment in financial transactions.

5 June 2008

Governor delivered a keynote address, entitled “Taking the Leap in Paradigm Shift of Banking - New Wave, New Ventures” at the 12th Malaysian Banking Summit organised by ASLI. Governor said that competitive pressures and global developments will continue to shape the transformation process of the financial sector. She highlighted that as a whole, Malaysian banking sector is sound, particularly the domestic banking institutions, which have benefited from the broad-based reforms and capacity building measures that were undertaken following the Asian financial crisis. She noted that the progress of the financial sector had surpassed initial expectations outlined in the Financial Sector Masterplan. Going forward, the industry’s liberalisation plan is aimed at reinforcing the role of the financial sector in the next phase of development, capitalising on core comparative advantages while reaping benefits from alliances and partnerships. Governor also highlighted that on the regulatory side, the Bank would continue to direct significant efforts and resources towards strengthening its surveillance capabilities to detect, monitor and to deal pre-emptively with emerging risks in the financial system.