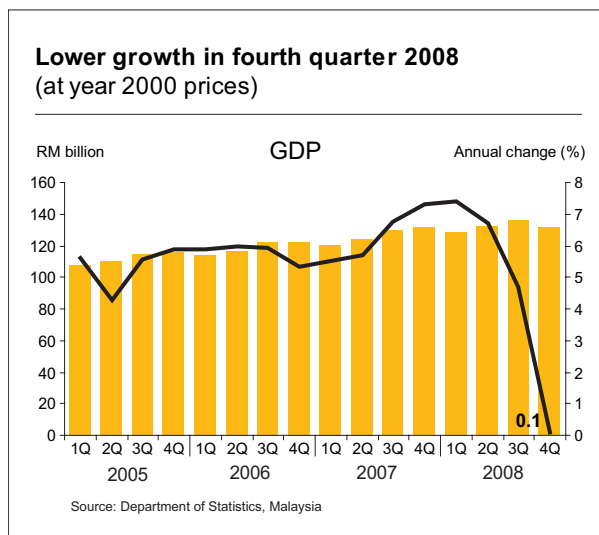


ECONOMIC AND FINANCIAL DEVELOPMENTS IN MALAYSIA IN THE FOURTH QUARTER OF 2008

OVERVIEW

Growth slowed in the fourth quarter

Growth of the Malaysian economy slowed to 0.1% (3Q 08: 4.7%) in the fourth quarter of 2008 as global economic conditions worsened significantly. Growth was affected by the sharply weaker external demand, that has resulted in a further decline in net real exports of goods and services by 40.1% (3Q 08: -14.8%).



Nevertheless, domestic demand continued to provide support to growth, driven mainly by private consumption and public spending. For the year as a whole, the Malaysian economy expanded by 4.6% (2007: 6.3%).

During the quarter, domestic demand expanded at 3.1% (3Q 08: 6.5%). Growth in private consumption moderated to 5.3% (3Q 08: 8.1%) as spending activity was constrained by higher retrenchments in the manufacturing sector, reduction in smallholders' income arising from the significant decline in commodity prices as well as lower consumer confidence. Public consumption, however, increased strongly by 13.8% (3Q 08: 6.9%), underpinned by higher expenditure on emoluments as well as supplies and services. Meanwhile, subdued investment activity led to a negative growth in gross fixed capital formation (-10.2%; 3Q 08: 3.1%) in the fourth quarter.

On the supply side, the slowdown was across all economic sectors, led by a sharp decline in the manufacturing sector (-8.8%; 3Q 08: 1.8%), particularly the export-oriented industries (-12.3%; 3Q 08: -1.1%) due to the significant contraction in global demand. Meanwhile, the domestic-oriented industries recorded a negative growth of 2.5% (3Q 08: 8.4%) as production of construction-related materials declined. The agriculture sector registered a lower growth of 0.5% (3Q 08: 3.0%) due to a moderation in production of palm oil while output for rubber declined. The mining sector contracted by 5.7% (3Q 08: -0.3%), following lower output of oil and gas. Meanwhile, construction activities declined by 1.6% (3Q 08: 1.2%) due to lower activity in the civil engineering sub-sector. During the quarter, the services sector remained the key driver of growth, expanding by 5.6% (3Q 08: 7.1%). The growth in the services sector was supported by the wholesale and retail trade, and accommodation and restaurant sub-sectors. Real estate and business services as well as utilities sub-sectors, however, experienced a contraction in view of the lower stock market and manufacturing activities.

Headline inflation moderated to 5.9% in the fourth quarter of 2008 (3Q 08: 8.4%), due mainly to a series of downward adjustments of retail fuel prices by the Government. The downward trend in inflation is expected to continue in 2009. Slowing economic growth is expected to contain both supply and demand pressures and rein in domestic price increases. This trend is confirmed by the numbers for the month of January 2009 during which inflation moderated to 3.9%.

In the external sector, the trade balance recorded a lower surplus of RM32.8 billion in the fourth quarter (3Q 08: RM41.8 billion). Exports declined (-7.4%; 3Q 08: 16.8%), reflecting the sharp contraction in manufactured exports. Performance of manufacturing exports was affected by lower demand for both E&E and non-E&E products from the major markets as well as weaker

global semiconductor prices. Growth in commodity exports (6.1%; 3Q 08: 48.1%) also moderated significantly, reflecting a lower growth in mineral exports while agriculture exports declined sharply due mainly to lower prices. The decline in gross imports (-12.3%; 3Q 08: 10.1%) was due to lower imports of intermediate and capital goods following weaker export performance and slower private investment activities.

On a cash basis, gross inflows of foreign direct investment (FDI) were lower at RM9.3 billion in the fourth quarter (3Q 08: RM21.6 billion), due mainly to a decline in inter-company borrowings. After adjusting for gross outflows due mainly to repayment of inter-company loans, net FDI amounted to RM3.4 billion (3Q 08: RM2 billion). The bulk of the net FDI was directed into the oil and gas sector as well as the services and manufacturing sectors. Overseas investment by Malaysian companies recorded a lower net outflow of RM6.6 billion (3Q 08: -RM16 billion), mainly for investment in the services and manufacturing sectors. Portfolio investment registered a lower net outflow of RM24.8 billion (3Q 08: -RM38 billion), as the major move to re-align asset allocation by fund managers has largely been completed.

The international reserves of Bank Negara Malaysia amounted to RM316.8 billion (equivalent to USD91.3 billion) as at 31 December 2008 and remained stable at RM317.7 billion (equivalent to USD91.6 billion) as at 13 February 2009. The reserves position is sufficient to finance 7.6 months of retained imports and is 4 times the short-term external debt.

OPR reduced as pre-emptive measure

The Overnight Policy Rate (OPR) was reduced by 25 basis points in November 2008 and by another 75 basis points in January 2009. To reduce further the cost of intermediation, the Statutory Reserve Requirement (SRR) was also reduced concurrently by 50 basis points and 150 basis points. These significant respective downward adjustments were to frontload the monetary stimulus to support domestic demand, given the increased downside risk to growth in an environment of

rapidly diminishing inflationary pressures. The sharper deterioration of the global economy in the fourth quarter and the increased risk of contraction of the domestic economy prompted the further reduction in the OPR by 50 basis points on 24 February 2009, and the SRR by 100 basis points.

Reflecting the change in the OPR in November 2008, interbank rates for all maturities fell accordingly and remained stable at their new levels thereafter. In terms of lending rates, the average base lending rate (BLR) of commercial banks (CBs) was lower at 6.48% as at end-December 2008 (end-September 2008: 6.72%). The average lending rate (ALR) on loans outstanding declined to 5.86% at end-December 2008, compared to 5.96% at end-September 2008. The reduction in fixed deposit (FD) rates was most pronounced at the 12 month tenure, as the floor was revised lower by 20 basis points to 3.5%. As at end-December 2008, the average quoted FD rates for tenures between 1 to 12 months were within the range of 3.01% and 3.5% respectively.

In the fourth quarter, credit conditions in Malaysia remained orderly despite the deteriorating global financial and economic conditions. While loan indicators showed some slowing in the demand for credit, demand for financing by businesses and households continued to be supported by the domestic banking institutions. On a net basis, banking system loans and PDS outstanding rose by 12.7% at end-2008. Total loans disbursements increased by 5.3% during the quarter, mainly accounted for by the business sector. Total loans outstanding increased at a higher pace at 12.8%. Although initially demonstrating cautiousness in extending credit, banking institutions have continued to be forthcoming in extending credit facilities.

Net funds raised in the capital market were significantly higher at RM14.3 billion in the fourth quarter. The increase was largely due to higher net funds raised by the public sector, which amounted to RM13.9 billion. In the private sector, net funds raised through the PDS market amounted to RM229 million, while funds raised through the equity market amounted to RM222 million.

M3, or broad money, expanded moderately by RM19 billion in the fourth quarter of 2008, or 11.9% on an annual basis at end-December 2008 amidst large external outflows arising from the de-leveraging process by global investors.

The ringgit depreciated against the US dollar during the fourth quarter following continued global de-leveraging activities. The ringgit weakened to RM3.6375 against the US dollar on 5 December 2008, representing a 13.9% decline from the 23 April 2008 peak of RM3.1315. Towards the end of the year, the ringgit experienced some recovery with the ringgit-US dollar exchange rate at 3.4640, as at 31 December 2008, 4.5% lower than the end-2007 level. Against other major currencies during the fourth quarter, the ringgit was stronger against the pound sterling by 24.5% and by 1.8% against the euro amid growing concerns over deteriorating economic conditions in the UK and euro area. The ringgit also appreciated against most regional currencies in the range of 0.3% to 15.9% during the period. The exception was the Chinese renminbi, against which the ringgit depreciated by 0.5%. During the period of 1 January to 24 February 2009, the ringgit depreciated against the US dollar by 5.6%, the pound sterling by 6.4% and the Japanese yen by 0.7%, but appreciated against the euro by 4.5%. The ringgit depreciated against regional currencies in the range of 0.2% to 5.6%, with the exception of the Korean won, the Indonesian rupiah and the Singapore dollar, against which the ringgit appreciated by 13.2%, 3% and 0.4% respectively.

Banking system remained sound

The financial position of the banking sector remained sound with the capacity to continue to support the financing needs of the economy. As at end-December 2008, the banking system's risk-weighted capital ratio (RWCR) and core capital ratio (CCR) were maintained at high levels of 12.7% and 10.6% respectively. Pre-tax profit (PBT) increased to RM5.1 billion (3Q 08: RM4.0 billion) with annualised average returns on assets

and equity of 1.5% (3Q 08: 1.5%) and 18.6% (3Q 08: 18.7%) respectively. Net NPLs improved by 5% to RM15.8 billion (3Q 08: RM16.6 billion) to account for a lower share of total net loans as at end-2008 (2.2%; 3Q 08: 2.4%).

Domestic demand is key as global crisis deepens

Latest developments show that the impact of the global financial crisis on the global economy is far broader and more severe than earlier anticipated. Its depth and contagion across the global economy was unprecedented with several of the large industrial countries and a number of the regional economies having slipped into recession. While global efforts have been intensified to counter the effects of the slowdown, risks remain on the downside and recovery is likely to be slow and protracted. Under these circumstances, the Asian economies have been adversely affected. The impact is already evident in export performance of several of the regional countries.

Being an integral part of the global economy, Malaysia has already felt the impact of the global slowdown. As exports declined, growth has increasingly relied on domestic demand, particularly private consumption and government spending. Continued access to financing, high savings and lower inflation would continue to lend support to the economy during this challenging period. The timely implementation of the fiscal stimulus and providing the necessary policy support to strengthen the domestic sources of growth will also be vital to supporting the overall growth. Bank Negara Malaysia also reduced the OPR by 75 basis points to 2.5% on 22 January 2009 and the Statutory Reserve Requirement (SRR) by 150 basis points to 2% effective 1 February 2009. On 24 February 2009, the OPR was reduced to 2%, while the SRR was reduced further to 1%. The Bank's efforts will continue to focus on ensuring access to credit. On 23 January 2009, Bank Negara Malaysia announced the establishment of the RM2 billion SME Assistance Guarantee Scheme.

DEVELOPMENTS IN THE FOURTH QUARTER OF 2008

INTERNATIONAL ECONOMIC ENVIRONMENT

Global recession deepened with feedback loop impacting financial sector

The global economy came under severe stress in the fourth quarter as the deepening recession in the advanced economies intensified the feedback loop from the real economy to the already fragile financial sector. While the initial measures were concentrated at reviving the financial sector, there was a distinct shift in emphasis towards the use of massive fiscal stimuli to counter the impact on growth. The dynamic interaction between firms cutting jobs, the loss of confidence and consumers holding back spending has led to severe contraction in private sector demand, accelerating the drop in global demand for goods and services and the correction in commodity prices. The more open emerging economies experienced double-digit declines in exports, resulting in a deterioration in growth. This has prompted aggressive policy responses in the form of large fiscal stimuli and monetary easing.

In the **US**, real GDP contracted for the second consecutive quarter by an annualised 3.8% in the fourth quarter (3Q 08: -0.5%), registering the biggest drop in 26 years. Private consumption expenditure declined further by 3.5% (3Q 08: -3.8%) but the more significant factor was the double-digit decline of 20.1% in fixed investment (3Q 08: -5.3%). The broad-based decline in fixed investment was due mainly to a large drop of 27.8% in business

equipment investment. Meanwhile, headline inflation fell sharply to 1.5% in the quarter (3Q 08: 5.2%), due to the large fall in gasoline prices and weaker demand.

Recession in **Japan** deepened further when the economy contracted sharply by an annualised 12.7% in the fourth quarter (3Q 08: -2.3%) following the record fall of 23.5% in exports during the quarter (3Q 08: 3.1%). The increasing breadth and depth of the decline in exports reflected the sharp fall in global demand for automobiles, electronics and other products amidst the sharp appreciation of the yen. Highlighting the strong reliance of Japan's manufacturing sector on exports, industrial production fell by 14.4% in the fourth quarter of 2008 (3Q 08: -1.9%), accompanied by shorter working hours and job cuts especially among the contract workers. This, among other factors, has pushed the consumer confidence index to an all-time low of 26.2 in December 2008, putting downward pressure on consumption. Inflation eased further to 1% in the fourth quarter (3Q 08: 2.4%).

Growth in the **euro area** contracted by 1.2% (3Q 08: 0.6%) in the fourth quarter, due to a combination of the further decline in exports in Germany and the intensifying of the credit crunch in other European economies. Domestic demand weakened further due to tighter bank lending conditions impacting both households' consumption and firms' investment activities.

Industrial Countries: Real GDP Growth

	2007		2008			Key contributing factors for 4Q growth
	4Q	Year	3Q	4Q	Year	
	Annual change (%)					
US ¹	-0.2	2.0	-0.5 ^r	-3.8 ^a	1.3 ^a	Sharp contraction in fixed investment mainly in business equipment.
UK	3.0	3.0	0.3	-1.9 ^a	0.7 ^a	Broad-based slowdown in services and manufacturing sectors.
Euro area	2.1	2.6	0.6	-1.2 ^p	0.7 ^p	Sharp contraction in Germany as well as deeper-than-expected decline in France and Italy.
Japan ¹	4.5	2.4	-2.3 ^r	-12.7 ^p	-0.7	Third consecutive annualised contraction following record fall in exports.

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

Source: National authorities

On the inflation front, prices moderated further to 2.3% in the fourth quarter (3Q 08: 3.8%). Meanwhile, the **UK** economy experienced a negative growth of 1.9% in the fourth quarter (3Q 08: 0.3%), its first decline since 1991. The contraction was broad-based across all sectors, particularly services (-1%). Inflation, meanwhile, continued to trend downwards to 3.9 % in the fourth quarter (3Q 08: 4.8%).

Against the backdrop of severe deterioration in growth prospects, worsening financial turmoil and falling commodity prices, central banks in the advanced economies continued with aggressive monetary easing. In the **US**, the **Federal Open Market Committee (FOMC)** lowered its Federal Funds rate from 1% to a range of between zero and 0.25% in December, effectively adopting a zero interest rate policy. The US authorities also adopted wide-ranging quantitative easing to improve market liquidity of debt instruments and to provide support for the housing market which had continued to weaken. Elsewhere, the **Bank of Japan** cut its overnight call rate by 20 basis points to 0.1% while the **European Central Bank (ECB)** reduced its overnight rate in December by 75 basis points, its largest cut in a decade, to 2.5%. The ECB again cut its interest rate on 15 January 2009 by 50 basis points to 2% as the recession deepened. Similarly, the **Bank of England (BoE)** eased its base lending rate in December by 100 basis points to 2%. The BoE cut interest rate further by 50 basis points to 1.5% in January 2009 and reduced another 50 basis points to 1% in February, a record low in the central bank's history.

Given the severity of the slowdown, the authorities, particularly in the advanced economies, have embarked on large fiscal stimuli to provide support to the real economy. The US announced a fiscal stimulus of USD787 billion or 5.7% of its GDP in February 2009. Similarly, large fiscal stimuli were also announced by the regional countries, including PR China (USD586 billion or 16% of GDP) in November 2008, and Singapore in January 2009 (USD13.7 billion or 8.4% of GDP).

In the fourth quarter, global **crude oil prices**¹ continued to decline to close at USD44.6 per barrel at the end of 2008 as the recession in

advanced economies deepened. Oil price hit a 5 year low of USD31.41 per barrel in mid-December 2008, a level not seen since December 2003, before stabilising between USD35 – 50 per barrel in the early part of 2009.

In the Asian region, the more open economies slipped into recessions while the growth of other regional economies decelerated sharply in the fourth quarter. Following the significant declines in their exports, growth in Singapore and Korea contracted by 4.2% (3Q 08: 0%) and 3.4% (3Q 08: 3.8%) respectively. The growth in PR China moderated sharply to 6.8% in the fourth quarter (3Q 08: 9%), following the slump in exports to the advanced economies. This has led to the subsequent sharp fall in PR China's imports from the rest of the region. The sharp fall in commodity prices and weaker external demand have, however, led to lower inflationary pressures in the region. In response, central banks across Asia have also reduced their interest rates to record lows to cushion their economies from the worsening global prospect. The Bank of Korea has eased its interest rate by 325 basis points since early October 2008 while PR China cut interest rates by 216 basis points since September 2008.

Selected Economies: Policy Responses

Country	Fiscal Stimulus		Monetary Policy	
	Amount (USD bn)	% of GDP ¹	Cumulative change since Jan 08 ² (basis points)	Current Rate (%)
Industrial				
US	787	5.7	-400 to -425	0 to 0.25
UK	31	1.5	-450	1.0
Euro area ²	271.3	2.7	-200	2.0
Japan	54	0.9	-40	0.1
Regional				
PR China	586	16	-216	5.31
Hong Kong SAR	1.4	0.7	-525	0.5
Indonesia	6.1	1.9	+25	8.25
Korea	11	1.6	-300	2.0
Malaysia	2.0	1.0	-125	2.0
Chinese Taipei	18	4.6	-212.5	1.25
Philippines ³	6.3	4.5	-25	5.0
Thailand	10	4.1	-175	1.5
Singapore	13.7	8.4	n.a.	n.a.

¹ Calculated based on 2007 nominal GDP

² Refers to Germany, France, Italy and Spain

³ Fiscal stimulus proposal to be finalised

Source: National authorities, Bank Negara Malaysia calculations

¹ Refers to WTI one-month futures on NYMEX

Regional Countries: Real GDP Growth

	2007		2008			Key contributing factors for 4Q growth
	4Q	Year	3Q	4Q	Year	
	Annual change (%)					
PR China	11.2	13.0 ^r	9.0	6.8	9.0	Lower growth from weaker exports and investment.
Indonesia	6.3	6.3	6.4 ^r	5.2	6.1	Growth supported by consumption and exports.
Philippines	6.4	7.2	5.0 ^r	4.5	4.6	Growth supported by consumption despite declines in exports and investment.
Hong Kong SAR	6.9	6.4	1.7	-2.5	2.5	Due to weaker exports and domestic demand.
Korea	5.7	5.0	3.8 ^r	-3.4 ^p	2.5	Broad-based declines in manufacturing, construction and services sectors.
Singapore	5.5 ^r	7.8 ^r	0.0 ^r	-4.2 ^r	1.1	Due to decline in manufacturing especially electronics and chemicals sectors.
Thailand	5.7	4.9	3.9 ^r	-4.3	2.6	Sharp contraction due to negative contribution from net exports.
Chinese Taipei	6.4	5.7	-1.1 ^r	-8.4 ^p	0.1	Sharp contraction in growth due to significant decline in exports and private investment.

^r Revised

^p Preliminary

Source: National authorities

In the **foreign exchange market**, the US dollar continued to appreciate against the euro and the pound sterling due to the de-leveraging process as well as market perception that the adjustments in the other advanced economies were lagging the US. The Japanese yen also strengthened against the US dollar due to the continued unwinding of carry trade activities and repatriation of funds back to Japan. Meanwhile, regional currencies depreciated against the US dollar, affected by the de-leveraging activities as well as the pull back of funds and credit from the region by investors and financial institutions amidst large loan

writedowns in the developed economies and weaker balance sheets.

Going forward, with financial markets remaining under severe stress and the real economy taking a sharp turn for the worse in spite of policy measures, the downside risks to global growth remain. The direction and magnitude of global economic crisis in the near term hinges critically on the effectiveness of the advanced economies to effectively implement policy measures to reflate demand and re-establish a functioning financial system, as well as the stimulus measures being introduced in the major emerging economies.

DEVELOPMENTS IN THE MALAYSIAN ECONOMY

Growth slowed down in the fourth quarter

Growth of the Malaysian economy slowed to 0.1% (3Q 08: 4.7%) in the fourth quarter of 2008, due mainly to sharply weaker external demand. Exports declined significantly following the deepening of the recession in several advanced economies as well as slower growth in the regional economies. Domestic demand provided the support to growth, driven by private and public consumption. On the supply side, growth was supported by the services sector, while manufacturing, mining and construction sectors contracted. Overall, the economy expanded by 4.6% in 2008 (2007: 6.3%).

Further moderation in domestic demand

Domestic demand moderated, with a growth of 3.1% (3Q 08: 6.5%) in the fourth quarter. During the quarter, households and businesses turned cautious, affected by the deterioration in the global economic environment, news of retrenchments and other cost-cutting measures undertaken in the manufacturing sector.

	2007		2008		
	4Q	Year	3Q	4Q	Year
	Annual change (%)				
Aggregate Domestic Demand (excluding stocks)	9.1	9.8	6.5	3.1	6.9
Consumption	8.7	9.9	7.8	7.4	9.1
<i>Private sector</i>	10.2	10.8	8.1	5.3	8.4
<i>Public sector</i>	4.2	6.6	6.9	13.8	11.6
Gross Fixed Capital Formation	10.2	9.6	3.1	-10.2	1.1
Net Exports	-12.3	-3.8	-14.8	-40.1	-3.8
<i>Exports of Goods and Services</i>	7.8	4.2	5.1	-13.4	1.5
<i>Imports of Goods and Services</i>	11.0	5.4	8.2	-10.1	2.2
GDP	7.3	6.3	4.7	0.1	4.6

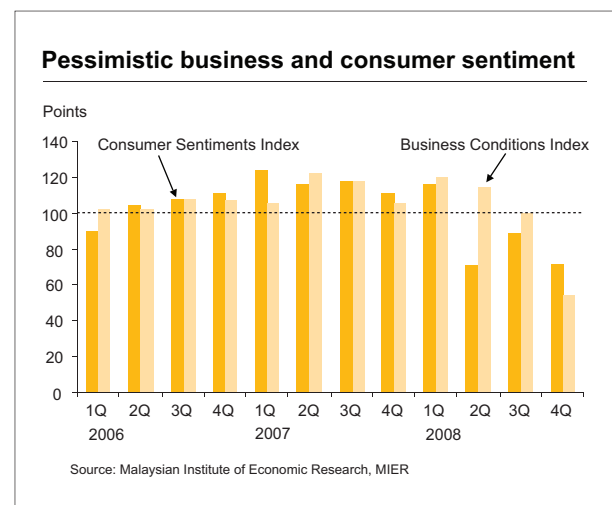
Source: Department of Statistics, Malaysia

Private consumption grew by 5.3% in the fourth quarter of 2008, supported by the reduction in retail pump prices, various promotions for the festivities as well as bonuses paid to civil servants in the month of December. Private consumption, however, was affected to some extent by higher retrenchments

in the manufacturing sector as well as lower smallholders' income following the significant declines in commodity prices. The moderation in private consumption was reflected in slower rate of increase of most of the consumption indicators such as credit card spending, imports of consumption goods and loans approved and disbursed to households, as well as the decline in sales of new passenger cars. The MIER Consumer Sentiments Index also dropped to 71.4 points (3Q 08: 88.9 points), reflecting the more pessimistic outlook on employment prospects and income expectations by households.

Meanwhile, **public consumption** grew strongly by 13.8% in the fourth quarter, underpinned by higher expenditure on emoluments while supplies and services remained high.

Gross fixed capital formation declined by 10.2% in the fourth quarter due mainly to the decline in both public and private investment activities. The decline in public investment was reflected in the slower disbursement of development expenditure during the quarter. Meanwhile, private investment activities weakened further during the quarter as reflected in the contraction of imports of capital goods and loans disbursed to the manufacturing and construction sectors. Business confidence also deteriorated significantly during the quarter as evident from the MIER Business Conditions Index which shed 45.8 points from the third quarter to 53.8 points in the fourth quarter.



Lower growth across all economic sectors

On the supply side, growth in all sectors of the economy was lower. Value added in the manufacturing sector declined sharply due mainly to the deterioration in export-oriented industries, particularly the electronics and electrical (E&E) industry. Output in the mining sector also contracted due to lower production of oil and gas, while the agriculture sector registered a lower growth amidst a moderation in the production of palm oil and a decline in the output of rubber. Construction activities also contracted due to weakness in the civil engineering sub-sector. Meanwhile, the services sector moderated, reflecting lower growth in the wholesale and retail trade as well as the finance and insurance sub-sectors, while the real estate and business services as well as the utilities sub-sectors experienced contraction.

Quarterly GDP by Kind of Economic Activity (at year 2000 prices)

	2007		2008		
	4Q	Year	3Q	4Q	Year
	Annual change in (%)				
Agriculture	4.7	2.2	3.0	0.5	3.8
Mining	3.5	3.3	-0.3	-5.7	-0.8
Manufacturing	5.6	3.1	1.8	-8.8	1.3
Construction	4.7	4.6	1.2	-1.6	2.1
Services	9.3	9.7	7.1	5.6	7.3
Real GDP (Annual Change)	7.3	6.3	4.7	0.1	4.6
Real GDP (Preceding Change)	0.8	6.3	3.1	-3.6	4.6

Source: Department of Statistics, Malaysia

Continued growth in the services sector

The **services sector** remained resilient, growing by 5.6% in the fourth quarter, supported by growth in the wholesale and retail trade and accommodation and restaurant sub-sectors. The services sector was the anchor of growth, with a contribution of 3 percentage points to the overall GDP growth.

The **wholesale and retail trade** sub-sector expanded at a moderate pace of 5.9% (3Q 08: 9.4%) as continued growth in retail spending on essential goods, the Year-end Malaysia Savings Sales and higher tourist arrivals, more than offset the sharp moderation in the motor vehicle trade segment. The **accommodation and restaurant** and **other services** sub-sectors expanded by 7.4% and 4.7% respectively, as both the sub-sectors benefited from the aggressive promotion of domestic tourism that contributed to the increased demand for recreational and entertainment-related services.

In the **communication** sub-sector, strong growth momentum was sustained, expanding by 6.3% (3Q 08: 7.4%) in the quarter. At the end of the fourth quarter, the cellular and broadband penetration rates increased to 96.8% and 21.1% respectively, buoyed by innovative promotions by the telecommunication providers.

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

	Share 2007 (%)	2007		2008		
		4Q	Year	3Q	4Q	Year
		Annual change in (%)				
Intermediate Services	43.7	10.2	11.7	6.1	2.7	6.0
Finance & insurance	19.9	10.0	11.1	10.0	3.5	7.7
Real estate & business services	9.8	11.1	18.2	-2.2	-0.4	1.5
Transport & storage	7.0	12.4	10.0	5.9	1.0	6.1
Communication	7.0	7.2	7.0	7.4	6.3	7.3
Final Services	56.3	8.6	8.1	7.9	7.8	8.4
Electricity, gas & water	5.6	3.0	3.9	2.5	-2.6	2.1
Wholesale & retail trade	22.8	12.9	12.5	9.4	5.9	9.8
Accommodation & restaurant	4.4	12.3	10.8	4.6	7.4	7.3
Government services	12.9	5.0	4.5	11.2	18.2	11.9
Other services	10.6	5.4	5.0	5.0	4.7	4.9
Total Services	100.0	9.3	9.7	7.1	5.6	7.3

Source: Department of Statistics, Malaysia

Selected Quarterly Indicators in the Services Sector

	2007	2008			
	4Q	1Q	2Q	3Q	4Q
Index					
MIER Consumer Sentiment Index	110.7	115.5	70.6	88.9	71.4
MIER Retail Trade Index	141.2	106.1	94.5	116.5	52.7
MIER Tourism Market Index	133.6	120.3	107.5	109.2	94.0
Annual change (%)					
Total consumption credit outstanding	7.3	7.6	9.6	9.7	9.0
Loans outstanding to the wholesale & retail trade, hotels & restaurants	7.2	10.1	15.4	14.0	8.9
Imports of consumption goods	3.8	5.6	21.3	16.2	4.1
Total sales of motor vehicles	19.0	24.6	27.1	10.5	-8.3
Container cargo handled (Port Klang and PTP)	14.4	9.7	9.4	16.4	-3.9

Source: Various sources

The growth in the **finance and insurance** sub-sector moderated to 3.5% (3Q 08: 10%), as fee income of the banking system declined following lower activity in the capital market. Reflecting the cautious attitude adopted by loan applicants, new loan applications and approvals also declined during the quarter. Nevertheless, lending activity remained firm as reflected in a higher growth in total loans outstanding (+12.8%; 3Q 08: +10.6%). Total loans disbursed by the banking system remained strong, expanding by 5.3% (3Q 08: 5.5%). Meanwhile, activity in the insurance segment, both for life and general insurance contracted, as reflected by the lower premium income from new businesses and vehicle sales. The **government services** sub-sector, on the other hand, recorded a higher growth during the quarter, reflecting the higher emoluments and bonuses paid.

The **transport and storage** sub-sector registered lower growth of 1% (3Q 08: 5.9%) as cargo-related transportation services showed the growing impact of the adverse external economic environment. The **real estate and business services** sub-sector registered its second consecutive quarter of decline, due mainly to the lower stock market and real estate-related activities during the quarter. Meanwhile, the **utilities** sub-sector posted its first contraction since 1997, affected by the

slower demand for electricity primarily from the manufacturing sector.

Manufacturing sector contracted

Value added in the **manufacturing sector** contracted significantly by 8.8% in the fourth quarter of 2008 (3Q 08: 1.8%) on account of weak external demand and moderating domestic economic conditions.

Performance in the Manufacturing Sector

	2007		2008		
	4Q	Year	3Q	4Q	Year
Annual change (%)					
Value Added (Constant Price)	5.6	3.1	1.8	-8.8	1.3
Overall Production	4.8	1.8	0.8	-10.4	0.2
Export-oriented industries	3.4	0.8	-1.1	-12.3	-1.7
<i>Of which:</i>					
Electronics and electrical	5.5	-0.9	-4.1	-18.3	-4.4
Electronics	10.3	1.5	-6.8	-20.4	-5.6
Electrical	-9.5	-8.7	5.6	-10.0	0.0
Chemicals and chemical products	-1.4	1.8	7.3	-7.7	1.6
Petroleum products ¹	3.7	5.4	-1.7	-5.2	-0.2
Rubber products	1.6	5.9	2.7	2.2	3.6
Off-estate processing	12.0	-0.5	3.6	1.8	9.7
Domestic-oriented industries	10.7	6.3	8.4	-2.5	8.1
<i>Of which:</i>					
Construction-related materials ²	5.1	5.1	7.4	-4.9	6.5
Fabricated metal products	19.0	19.4	-6.4	-19.7	-0.9
Transport equipment	15.3	-6.0	25.5	14.9	23.5
Food	8.3	7.6	6.7	0.5	7.1

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

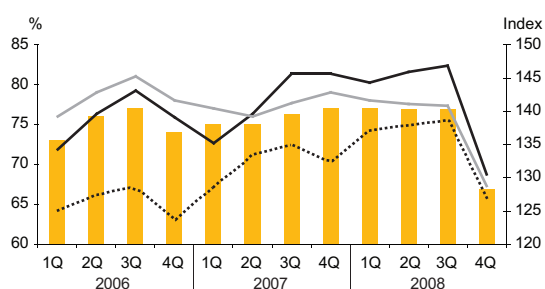
Source: Department of Statistics, Malaysia

Production in **export-oriented industries** declined considerably as the **electronics and electrical (E&E) industry** registered a sharp decline (-18.3%; 3Q 08: -4.1%). The decline in E&E was in tandem with the sharp contraction in global demand. Many manufacturers adopted various cost-cutting measures in response to this decline in demand including temporary shutdown of plants and shorter working weeks. Output of **resource-based industries** also contracted during the quarter. Depressed external demand and more moderate growth in the transport equipment industry resulted in the decline in output of chemical and plastic products segments. The moderation in feedstock as well as the decline in commodity prices towards the end of the year impacted the performance of petroleum and off-estate processing segments. Meanwhile, continued demand for medical and hygiene rubber gloves lent some support to the rubber products industry.

Output of **domestic-oriented industries** declined in the fourth quarter, weighed down mainly by the weakness in production of construction-related materials, following slower activities in the construction sector. The sustained growth in the consumer-related products partly cushioned the impact.

Against this backdrop of weak demand, the overall capacity utilisation rate in the manufacturing sector fell to 67% in the fourth quarter (3Q 08: 77%), with the export- and domestic-oriented industries operating at 67% and 65% respectively (3Q 08: 77% and 75% respectively).

Lower Capacity Utilisation Rate in the Manufacturing Sector* in line with Production



*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
Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Lower activity in commodities

The **agriculture sector** registered a lower growth of 0.5% (3Q 08: 3%) during the quarter due to a slowdown in palm oil production (3.6%; 3Q 08: 4.9%) amidst a downturn in yields, while rubber output declined substantially by 28.4% due to lower prices, which reduced smallholders' tapping activity. Meanwhile, the **mining sector** recorded a decline of 5.7% following the continued contraction in natural gas production by 5.5% and a reduction of 5.6% in the output of crude oil to 678,914 barrels per day.

Performance in the Agriculture Sector

	2007		2008		
	4Q	Year	3Q	4Q	Year
	Annual change (%)				
Value Added (at year 2000 prices)	4.7	2.2	3.0	0.5	3.8
Industrial Crops	6.1	0.0	0.6	-2.9	3.2
Food Crops	2.8	5.3	6.4	5.5	4.7
Production					
Of which:					
Crude palm oil	12.9	-0.4	4.9	3.6	12.1
Rubber	-7.6	-6.6	-4.2	-28.4	-10.1
Fish	4.9	0.2	10.7	7.1	5.2
Livestock	6.5	9.9	9.9	3.0	4.3

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

Performance in the Mining Sector

	2007		2008		
	4Q	Year	3Q	4Q	Year
	Annual change (%)				
Value Added (at year 2000 prices)	3.5	3.3	-0.3	-5.7	-0.8
Production					
Of which:					
Crude oil and condensates	5.8	2.4	3.5	-5.6	2.0
Natural gas (net)	-1.8	1.9	-6.4	-5.5	-4.9

Source: PETRONAS
Department of Statistics, Malaysia

Slowdown in the construction sector

Growth of the **construction sector** declined by 1.6% during the quarter (3Q 08: 1.2%) due to lower activity in the civil engineering sub-sector. However, growth in the residential segment remained positive, supported by on-going activities in the high-end segment. The non-residential segment continued to grow due to the continued construction of office buildings, particularly in the Klang Valley and university facilities.

Construction Indicators

	2007		2008		
	4Q	Year	3Q	4Q	Year
	Annual change (%)				
New sales and advertising permits	-3.1	2.0	-30.1	-47.8	-18.9
Housing approvals	-6.0	-11.5	-51.5	-53.8	-18.8
Production of construction-related materials	5.1	5.0	7.4	-4.9	6.5
Loans approved for construction	27.7	54.8	-13.4	-25.2	-1.7
Imports of construction materials and mineral products	38.8	12.9	5.2	-15.8 ¹	2.3 ²

¹Oct-Nov 2008

²Jan-Nov 2008

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

Inflation moderated in the fourth quarter

The headline inflation rate, as measured by the change in the Consumer Price Index (CPI), moderated to 5.9% in the fourth quarter of 2008 (3Q 08: 8.4%), due mainly to the series of downward adjustments to retail fuel prices by the Government. As a result, inflation in the *transport* category moderated significantly to 6.6% in the fourth quarter (3Q 08: 20.9%), contributing 91.1% to the overall lower inflation during the quarter. Inflation in the *food and non-alcoholic beverages* category also moderated slightly to 11.2% during the period (3Q 08: 11.7%). Inflation in the *alcoholic beverages and*

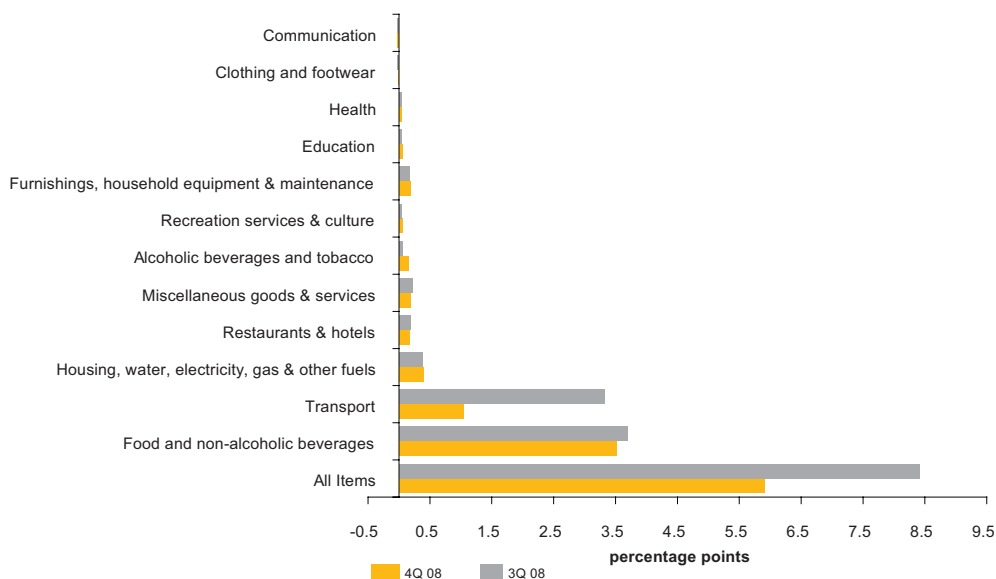
tobacco category however, increased to 8.4% (3Q 08: 3.1%), reflecting the 20% rise in excise duties on cigarettes in September.

The downward trend in inflation is expected to continue in 2009. Slowing economic growth is expected to exert downward pressures on domestic prices.

The Producer Price Index (PPI) turned sharply and declined by 0.1% in the fourth quarter of 2008 (3Q 08: 11.4%). This reversal in producer prices was across the board, with all PPI components recording substantially lower inflation rates compared to the previous quarter. Prices in the commodity-related component of the PPI fell significantly by 1.7% (3Q 08: 33%), mirroring the sharp drop in global commodity prices. Meanwhile, prices in the non-commodity-related component of the PPI continued to increase, albeit at a slower pace of 0.6% (3Q 08: 3%).

In terms of composition, both the local and imported components of the PPI recorded lower inflation rates compared to the previous quarter. On average, prices in the local component of the PPI remained constant in the fourth quarter (3Q 08: 15%), while prices in the imported component of the PPI declined slightly by 0.2% (3Q 08: 4.3%).

Contribution to Consumer Price Inflation

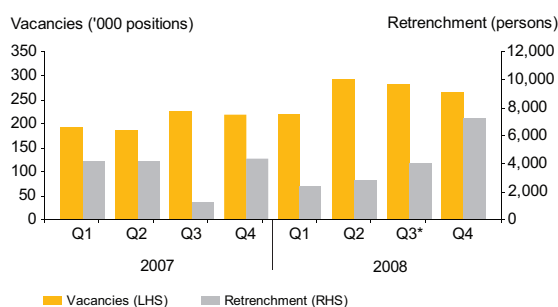


Source: Department of Statistics, Malaysia

Weaker labour market conditions

Labour market conditions weakened in the fourth quarter as reflected in higher retrenchments while demand for labour moderated. Total retrenchments reported by the Ministry of Human Resources increased to 7,254 persons (3Q 08: 3,997 persons), reflecting higher retrenchments in all sectors. Given the sharp deterioration in external demand, about 68% of total retrenchments were in the manufacturing sector, particularly in the E&E industry (50% of total retrenchments). Meanwhile, retrenchments in the services sector (27% share), occurred mainly in the wholesale and retail trade as well as accommodation and restaurant sub-sectors. Corresponding to the uncertain business environment, total vacancies in the Electronic Labour Exchange moderated to 264,674 positions (3Q 08: 282,006 positions) with lower job openings for the mid- and lower job categories. In the manufacturing sector, labour productivity growth declined by 6.8% (3Q 08: 6.4%) in line with weaker sales.

Labour Market Conditions

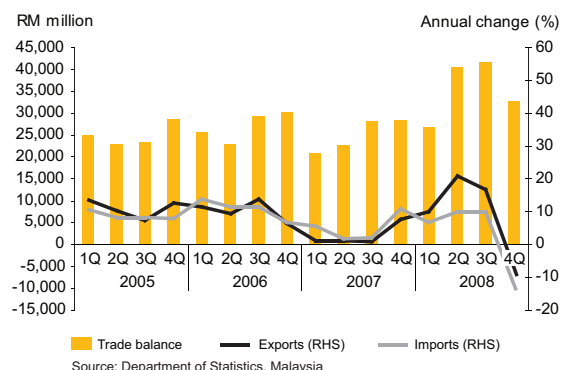


*Reflects adjusted retrenchments for Q3 08
Source: Ministry of Human Resources

Exports and imports contracted

Gross exports and imports contracted by 7.4% and 12.3% respectively in the fourth quarter of 2008. The weaker external demand conditions, which intensified in the fourth quarter, resulted in a sharp decline in manufactured exports and moderation in exports of commodities. The **trade surplus** narrowed to RM32.8 billion during the quarter (3Q 08: RM41.8 billion).

Trade Balance



Source: Department of Statistics, Malaysia

Trade Account

	2007		2008 ¹		
	4Q	Year	3Q	4Q	Year
	Annual change (%)				
Gross Exports	7.6	2.7	16.8	-7.4	9.6
Manufactured	1.2	0.2	8.5	-11.2	1.8
E&E	-2.5	-5.2	4.5	-16.3	-3.4
Non-E&E	7.0	9.0	14.2	-4.3	8.9
Commodities	1.2	13.4	48.1	6.1	38.5
Agriculture	31.4	24.4	37.5	-10.4	32.3
Minerals	37.7	7.0	55.8	16.9	42.4
Gross Imports	10.9	5.0	10.1	-12.3	3.3
Capital goods	17.3	7.2	-2.3	-13.2	0.0
Intermediate goods	13.6	6.9	17.2	-12.4	5.6
Consumption goods	3.8	3.6	16.2	4.1	11.6
Trade balance (RM billion)	28.4	100.3	41.8	32.8	142.0

¹Malaysia's trade classification has been revised in April 2008 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: MATRADE and Department of Statistics, Malaysia

The sharp decline in **manufactured exports** reflected contraction in the exports of both E&E and non-E&E products. Electronic exports declined further due mainly to lower demand from the US, Japan, EU and regional countries as well as weaker global semiconductor prices. Meanwhile, growth in electrical exports turned negative due to a broad-based decline in demand for industrial, commercial and household products. Non-E&E exports, both resource- and non-resourced based products, also recorded negative growth due to both falling demand and lower commodity prices. The weaker exports of chemicals and chemical products, rubber and petroleum products reflected lower commodity prices, while the decline in exports of iron and steel products, manufactures of metal and plastic was due to slower demand.

Malaysia: Direction of Exports

	2007		2008			2007		2008		
	4Q	Year	3Q	4Q	Year	4Q	Year	3Q	4Q	Year
	Annual change (%)					Share of total exports (%)				
United States	-15.8	-14.5	-9.9	-22.2	-12.5	14.3	15.6	11.9	12.1	12.5
European Union (EU)¹	-3.2	3.6	1.0	-14.1	-3.8	12.5	12.9	11.1	11.6	11.3
Selected ASEAN countries²	15.0	1.2	20.7	-15.1	9.9	26.4	25.5	25.8	24.2	25.6
North East Asia	19.2	10.4	26.7	-18.3	10.9	20.5	19.9	21.2	18.1	20.1
<i>People's Republic of China</i>	32.5	24.3	35.4	-18.4	19.2	9.5	8.8	10.7	8.4	9.5
<i>Hong Kong SAR</i>	13.1	-4.0	9.3	-22.6	1.3	4.7	4.6	4.3	4.0	4.3
<i>Chinese Taipei</i>	1.6	2.6	14.2	-22.2	-1.4	2.6	2.7	2.6	2.2	2.4
<i>Korea</i>	11.5	8.2	38.1	-10.1	12.4	3.7	3.8	3.6	3.6	3.9
West Asia	2.6	18.1	54.6	29.7	38.1	2.9	3.1	4.5	4.0	3.9
India	2.5	7.6	19.1	9.9	22.4	3.4	3.3	3.7	4.0	3.7
Total exports	7.6	2.7	16.8	-7.4	9.6	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

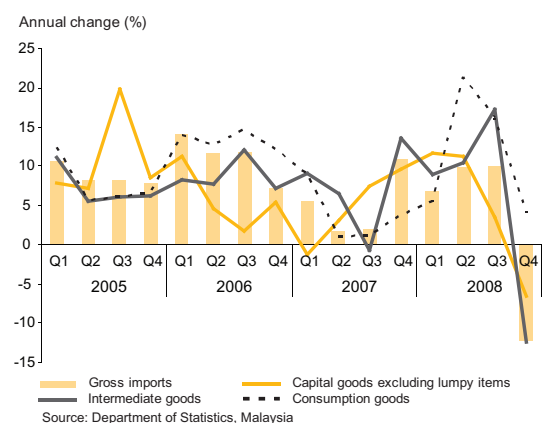
Growth in **commodity exports** moderated significantly due mainly to lower prices. While lower prices and weaker demand for crude palm oil and rubber led to the negative growth in agriculture exports, the moderation in mineral exports was due mainly to the sharp decline in crude oil prices. LNG exports, however, continued to provide some support to export growth.

In tandem with the sharper decline in manufactured exports and slower private investment activities, **gross imports** also contracted, reflecting declines in both intermediate and capital goods. Meanwhile, growth in consumption imports moderated as consumers turned more cautious and prudent in their spending.

Higher net inflows of FDI and lower net outflows of portfolio funds

On a cash basis, gross inflows of **foreign direct investment (FDI)**² were lower at RM9.3 billion in the fourth quarter (3Q 08: RM21.6 billion), reflecting mainly the decline in inter-company loans. After adjusting for gross outflows due mainly to repayment of inter-company loans, net FDI amounted to RM3.4 billion (3Q 08: RM2 billion). During the quarter, net FDI was focused mainly on the oil and gas sector, followed by the services and manufacturing sectors. FDI in the services sector was channelled mainly into the finance and insurance, real estate and business services as well as the transport and

Import Growth



communication sub-sectors. Meanwhile, in the manufacturing sector, FDI was mainly for the production of solar cells and downstream petroleum activities.

Overseas investment by Malaysian companies was lower, recording a net outflow of RM6.6 billion (3Q 08: -RM16 billion), attributed mainly to lower net extension of inter-company loans to subsidiaries abroad. The bulk of overseas investments was in the services sector, particularly for the completion of the acquisition of a strategic stake in the Indonesian finance and insurance sub-sector as well as investments in the real estate and business services, and wholesale and

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

retail trade sub-sectors. Meanwhile, overseas investments in the manufacturing sector were channelled mainly into the electrical and electronics and automotive industries.

Portfolio investment registered a lower net outflow of RM24.8 billion (3Q 08: -RM38 billion), reflecting mainly lower net liquidation of debt instruments by foreign investors. The bulk of the outflows during the quarter was due to net liquidation of equities, particularly in October 2008 when the global sell-down was at its peak. The outflows subsided thereafter as the intensity of the global deleveraging of stocks eased towards end-year.

External debt declined

As at end-2008, Malaysia's total external debt declined to RM235.6 billion or USD67.2 billion (end-September 2008: RM253.9 billion or USD72.7 billion), equivalent to 33.6% of GNI. The **medium- and long-term external debt** increased to RM155.6 billion, arising mainly from the depreciation of the ringgit against the US dollar and Japanese yen during the quarter. There was also a net

drawdown of external loans by the private sector (+RM1 billion). Meanwhile, the public sector continued to record a net repayment (-RM0.4 billion).

The total **short-term external debt** declined significantly to RM80 billion or USD22.8 billion due mainly to the de-leveraging activities by some foreign banks following their weaker balance sheets. As at end-2008, the short-term debt accounted for 34% of total external debt and was 25.3% of the net international reserves.

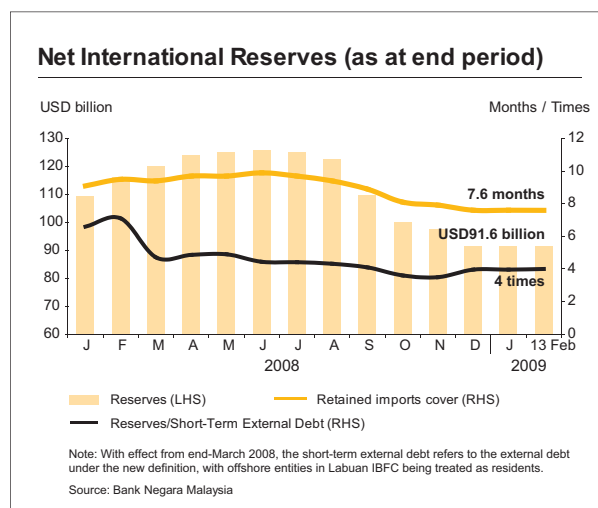
International reserves

The international reserves of Bank Negara Malaysia amounted to RM316.8 billion (equivalent to USD91.3 billion) as at 31 December 2008. The level of reserves has taken into account the quarterly adjustment of the foreign exchange revaluation loss, following the strengthening of the ringgit against some of the major currencies during the quarter. The reserves amounted to RM317.7 billion (equivalent to USD91.6 billion) as at 13 February 2009 and is sufficient to finance 7.6 months of retained imports and cover 4 times the short-term external debt.

	2008	
	3Q	4Q ^a
	RM billion	
Medium- and long-term debt	151.3	155.6
Public sector	77.8	79.9
Private sector	73.5	75.7
Short-term debt ¹	102.6	80.0
Total external debt	253.9	235.6
- USD billion equivalent	72.7	67.2

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

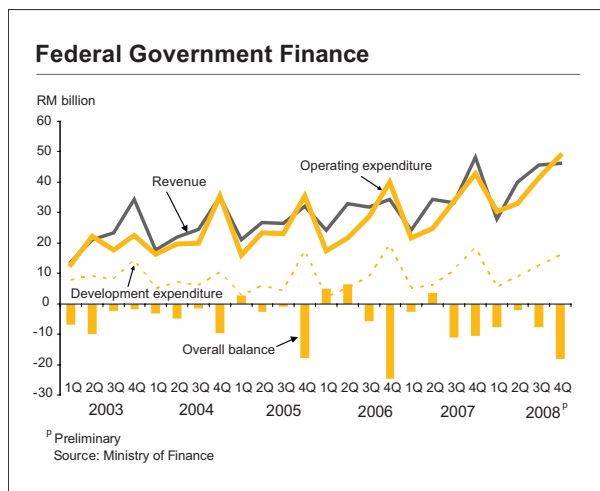
Source: Ministry of Finance, Malaysia and Bank Negara Malaysia



Fiscal deficit of 4.8% in 2008

The Federal Government intensified its efforts to increase the disbursement of funds in the fourth quarter. As a result, the budgetary operations of the Federal Government were expansionary, recording a fiscal deficit of 4.8% of GDP for the year (4Q 08: -10.3% of GDP). Higher operating expenditure was recorded during the period, mainly for payments of supplies and services, as well as subsidies. Development expenditure

was higher than the preceding quarter, with funds channelled largely to the trade and industry, defence, and education sectors. Nevertheless, it was lower when compared on a year-on-year basis. Meanwhile, revenue from sales tax, corporate income tax and oil earnings were the main contributors to total revenue. The fiscal deficit was financed mainly from domestic borrowings. As at end-2008, total outstanding debt of the Federal Government amounted to RM306.4 billion or 41.4% of GDP.



Federal Government Finance

	2007		2008 ^P		
	4Q	Year	3Q	4Q	Year
	RM billion				
Revenue	48.2	139.9	45.7	46.3	159.8
% growth	40.0	13.2	37.3	-3.9	14.2
Operating expenditure	42.9	123.1	41.4	48.9	153.5
% growth	7.3	14.3	22.7	13.8	24.7
Current account	5.3	16.8	4.3	-2.6	6.3
% of GDP	3.0	2.6	2.2	-1.4	0.8
Gross development expenditure	18.2	40.6	12.5	16.0	42.8
% growth	-6.0	13.3	16.2	-12.0	5.6
Overall balance	-10.5	-20.7	-7.8	-18.2	-35.6
% of GDP	-5.9	-3.2	-3.9	-10.3	-4.8
Memo item:					
Total gross expenditure	61.1	163.6	53.9	64.9	196.3
% growth	3.0	14.0	21.1	6.2	20.0
Total Federal Government debt (as at end-period)	266.7	266.7	288.1	306.4	306.4
% of GDP	41.6	41.6	38.9	41.4	41.4
Domestic debt	247.1	247.1	268.7	286.1	286.1
% of GDP	38.5	38.5	36.3	38.6	38.6
External debt	19.6	19.6	19.4	20.3	20.3
% of GDP	3.1	3.1	2.6	2.7	2.7

^P Preliminary

Source: Ministry of Finance

MONETARY AND FINANCIAL DEVELOPMENTS

Interest rates were reduced following the cut in the OPR

The Overnight Policy Rate (OPR) was reduced by 25 basis points in November 2008 and by another 75 basis points in January 2009. To reduce further the cost of intermediation, the Statutory Reserve Requirement (SRR) was also reduced concurrently by 50 basis points and 150 basis points. These significant respective downward adjustments were to frontload the monetary stimulus to support domestic demand, given the increased downside risk to growth in an environment of rapidly diminishing inflationary pressures. The sharper deterioration of the global economy in the fourth quarter and the increased risk of contraction of the domestic economy prompted the further reduction in the OPR by 50 basis points on 24 February 2009, and the SRR by 100 basis points.

Interbank rates of various maturities were stable prior to the monetary response. During the period, the daily weighted overnight interbank rate moved within a narrow range of 3.49% - 3.51%. Following the reduction in the OPR, the daily weighted average overnight interbank rate decreased and stabilised at a lower range of 3.24% - 3.25% during the period 25 November – 31 December 2008. Interbank rates of other maturities also softened accordingly, and remained stable at their new levels during the same period.

In terms of lending rates, the average base lending rate (BLR) of commercial banks (CBs) was lower at 6.48% as at end-December 2008 (end-September 2008: 6.72%), as 20 banks lowered their BLR in response to the reduction in the OPR. Accordingly, existing loans with variable rates were re-priced lower in the fourth quarter. New loans were also contracted at lower rates after the reduction in the OPR. As a result, the average lending rate (ALR) on loans outstanding

softened to 5.86% at end-December 2008, compared to 5.96% at end-September 2008.

Similarly, the average quoted fixed deposit (FD) rates of CBs decreased in the fourth quarter. The reduction in FD rates was most pronounced at the 12 month tenure, as the floor was revised downward by 20 basis points to 3.5%. As at end-December 2008, the average quoted FD interest rates for tenures between 1 to 12 months were within the range of 3.01% and 3.5% respectively.

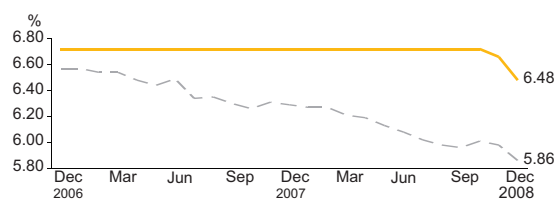
In contrast to nominal rates, real interest rates increased in the fourth quarter, as inflation moderated faster compared to the reduction in nominal interest rates.

Interest Rates

	2007	2008	
	4Q	3Q	4Q
	At end-period (%)		
Overnight Policy Rate (OPR)	3.50	3.50	3.25
Interbank rates			
Overnight	3.49	3.49	3.25
1-month	3.56	3.57	3.30
Base lending rates (BLR)			
Commercial banks	6.72	6.72	6.48
Average lending rates (ALR)			
Commercial banks	6.29	5.96	5.86
Fixed deposit rates			
Commercial banks			
3-month	3.15	3.14	3.04
12-month	3.70	3.70	3.50

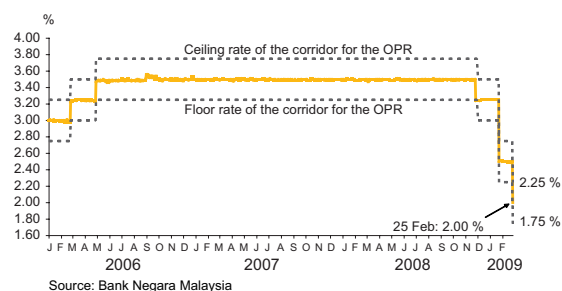
Source: Bank Negara Malaysia

Lending Rates of Commercial Banks (Average for the period)



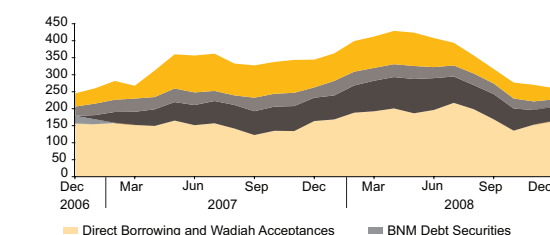
Source: Bank Negara Malaysia

Daily Weighted Average Overnight Interbank Rate



Source: Bank Negara Malaysia

Outstanding Liquidity Placed with Bank Negara Malaysia (At end-period, RM billion)



Source: Bank Negara Malaysia

M3 rose at a more moderate pace

M3, or broad money, expanded by RM19 billion in the fourth quarter of 2008. The pace of annual broad money growth continued to moderate, however, decreasing to 11.9% at end-December 2008 (end-September 2008: 13.5%) amidst large external outflows arising from the repatriation of funds by global investors. As a result, net foreign assets exerted a contractionary impact on broad money in the fourth quarter.

In contrast, domestic factors supported broad money growth. Higher government spending exerted an expansionary impact on M3. Meanwhile, claims on the private sector also increased, as banking institutions continued to supply credit to the private sector. Loans outstanding, however, increased by a more moderate amount in the fourth quarter.

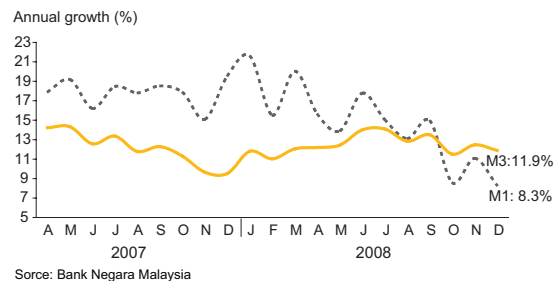
Similarly, M1 increased at a more modest annual pace of 8.3%, or RM3.3 billion during the fourth quarter.

Private sector financing in the fourth quarter remained steady

In the fourth quarter, credit conditions in Malaysia remained orderly despite the deteriorating global financial and economic conditions. While loan indicators show some slowing in the demand for credit, demand for financing by businesses and households continued to be supported by the domestic banking institutions. As a result, overall gross financing raised by the private sector through the banking system and the capital market was steady at RM167.1 billion in the fourth quarter (quarterly average of RM157.5 billion during the period 2006 - 2008). During the quarter, new issuances of private debt securities (PDS) were slightly lower, notably in November, as businesses delayed bond issuances. On a net basis, banking system loans and PDS outstanding rose by 12.7% at end-2008 (end-September 2008: 13.4%).

The contraction in exports and private investment as well as moderation in the pace of private consumption activities in the fourth quarter led to slower demand for financing from both the business and household sectors. Within the business sector, new loans applied declined across all the economic sectors,

Monetary Aggregates



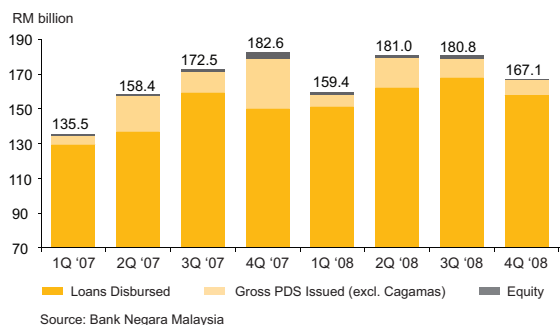
Determinants of Broad Money, M3

	Change during the period				
	2007		2008		
	3Q	4Q	2Q	3Q	
	RM billion				
M3	15.6	28.5	14.7	13.7	19.0
Net claims on Government	10.6	8.5	-5.1	14.5	23.1
Claims on private sector	32.9	-0.8	26.1	32.7	19.0
Loans	30.6	-0.6	23.5	25.6	10.9
Securities	2.3	-0.2	2.7	7.1	8.1
Net foreign assets ¹	-21.2	21.1	2.9	-57.3	-38.8
BNM	-7.6	7.2	15.9	-32.2	-49.2
Banking system	-13.5	14.0	-13.0	-25.0	10.5
Other influences	-6.7	-0.4	-9.3	23.8	15.6

¹ Pre-revaluation

Source: Bank Negara Malaysia.

Gross Private Sector Financing through Banking System and Capital Market



with the exception of the wholesale and retail trade sector. Although initially demonstrating cautiousness in extending credit, banking institutions have continued to be forthcoming in extending credit facilities. Business loan approvals over applications increased from 52.6% in third quarter to 56.8% in the fourth quarter. Meanwhile, disbursements to businesses continued to register positive annual growth. In particular, loans disbursed for the purpose of working capital rose further by 12.2% in the fourth quarter (3Q 08: 32%). Accordingly,

Financing of the Private Sector through Banking System and Capital Market

	During the period (RM billion)				Annual growth (%)		
	2007	4Q 07	3Q 08	4Q 08	2007	3Q 08	4Q 08
Gross total financing	648.9	182.6	180.8	167.1	17.4	4.8	-8.5
Loans disbursed*	575.3	150.0	168.1	157.9	10.6	5.5	5.3
Gross PDS (excl. Cagamas)	66.5	28.7	10.5	9.0	116.4	-12.9	-68.9
Equity	7.1	3.8	2.2	0.2	272.0	93.9	-94.2
Outstanding total financing (A)+(B)	88.0	20.1	30.4	16.1	11.3	13.4	12.7
Banking system	59.7	5.6	28.8	15.7	9.3	11.2	12.5
Loans outstanding (A)	51.2	-0.1	26.8	13.8	8.6	10.6	12.8
Holding of PDS	8.5	5.7	1.9	1.9	17.6	18.5	9.9
PDS outstanding (B)	36.8	20.2	3.5	2.2	19.6	22.4	12.4
Memorandum item							
Gross PDS (incl. Cagamas)	69.4	28.7	11.0	9.0	78.4	-8.8	-68.9

* Banking system loans include loans sold to Cagamas

Source: Bank Negara Malaysia

business loans outstanding grew at an annual growth rate of 13.2% at end-December 2008.

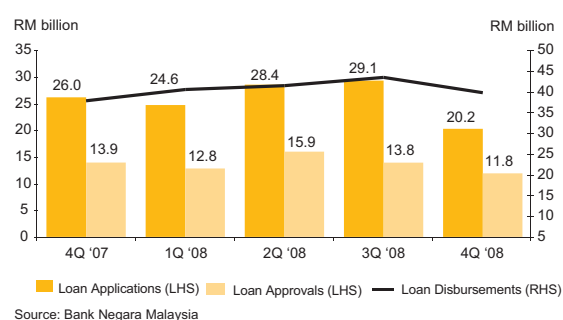
For the household sector, concerns over income prospects led to more cautious spending behaviour and a moderation in applications for consumer loans. The supply conditions for household loans remained favourable, with the ratio of household loan approvals to applications remaining above 60%. Disbursements to the household sector continued to register positive annual growth, supported mainly by housing and personal loans. Household loans outstanding grew at a sustained rate of 9.1% at end-December 2008 (end-September 2008: 9.1%).

Higher net funds raised in the capital market

Net funds raised in the capital market were higher at RM14.3 billion in the fourth quarter (3Q 08: RM6.6 billion). The increase was largely due to higher funds raised by the public sector. Funds were raised through the issuance of the 10-year Government Investment Issues (GII), and the re-opening of the 3-year, 5-year and 10-year Malaysian Government Securities (MGS). After adjusting for redemptions, net funds raised by the public sector amounted to RM13.9 billion.

Meanwhile, in the private sector, gross funds raised from the private debt securities (PDS) market declined from RM11 billion in the third quarter to RM9 billion in the fourth quarter. Issuers delayed their issuances in the month of November as businesses evaluated the credit conditions in an environment of highly

Bank Lending to SMEs



volatile global financial conditions. Funds raised during the quarter were by companies in the finance and insurance as well as real estate and business services sub-sectors. During the quarter, PDS was mostly issued to finance new investments (65.5%).

In the equity market, funds raised totalled RM222 million compared to RM2.2 billion in the third quarter. The decline was due mainly to weak market sentiments and heightened risk aversion. The bulk of the funds was raised through rights issues (RM164 million).

Secondary trading in the bond market increased

Total trading in the secondary market rose to RM165.8 billion in the fourth quarter (3Q 08: RM160.7 billion). Government securities (MGS and GII) accounted for 93% of total trades. In terms of liquidity, the MGS was the most liquid paper, registering a liquidity ratio of 0.69, followed by the GII with a liquidity ratio of 0.23.

Loan Indicators

	During the period (RM billion)				Annual Growth (%)			
	2007	4Q 07	3Q 08	4Q 08	2007	4Q 07	3Q 08	4Q 08
Total								
Loan applications	457.5	131.2	136.0	103.4	52.1	71.0	10.4	-21.2
Loan approvals	298.6	87.9	78.2	61.6	58.6	77.1	5.1	-30.0
Loan disbursements	575.3	150.0	168.1	157.9	10.6	18.0	5.5	5.3
Loan repayments	518.7	153.8	145.6	143.4	8.5	25.6	17.6	-6.8
Change in loan outstanding*	51.2	-0.1	26.8	13.8	8.6	8.6	10.6	12.8
Of which:								
Business enterprises**								
Loan applications	262.6	77.3	74.8	51.9	63.1	87.3	9.5	-32.9
Loan approvals	181.5	56.7	39.4	29.5	88.4	101.8	-4.2	-48.0
Loan disbursements	405.8	105.1	120.8	112.6	9.7	17.2	6.1	7.1
Loan repayments	370.3	115.0	104.3	101.9	5.3	30.2	21.0	-11.4
Change in loan outstanding*	24.4	-10.1	14.1	-1.4	10.3	10.3	9.5	13.2
SMEs**								
Loan applications	99.1	26.0	29.1	20.2	38.8	31.5	1.4	-22.5
Loan approvals	55.1	13.9	13.8	11.8	37.1	17.0	-14.7	-14.5
Loan disbursements	141.7	37.6	43.2	39.6	5.6	13.4	19.9	5.2
Loan repayments	126.8	34.6	38.2	36.1	3.5	10.2	23.0	4.5
Change in loan outstanding*	9.5	1.8	2.6	0.1	9.1	9.1	11.0	9.4
Large corporations								
Loan applications	163.5	51.3	45.6	31.7	82.4	138.7	15.4	-38.1
Loan approvals	126.4	42.9	25.5	17.7	125.2	163.6	2.8	-58.8
Loan disbursements	264.1	67.5	77.6	73.0	12.1	19.4	-0.3	8.2
Loan repayments	243.5	80.4	66.1	65.8	6.2	41.3	19.8	-18.2
Change in loan outstanding*	14.9	-11.9	11.5	-1.5	11.3	11.3	8.4	16.2
Households								
Loan applications	194.9	53.9	61.2	51.5	39.4	51.9	11.4	-4.4
Loan approvals	117.1	31.2	38.8	32.1	27.3	44.8	16.5	2.8
Loan disbursements	169.5	44.9	47.3	45.4	12.8	19.9	4.2	1.0
Loan repayments	148.5	38.8	41.4	41.5	17.3	13.8	9.8	7.0
Change in loan outstanding*	24.5	7.2	9.8	7.9	7.4	7.4	9.1	9.1

* The annual growth is for end-period

** Include loans to individual businesses

Source: Bank Negara Malaysia

Loans by Sector

	Loans disbursed					Loans out-standing	
	During the period				Share of total	Share of total	
	2007	4Q 07	3Q 08	4Q 08			
	(RM billion)				(%)		
Business enterprises	405.8	105.1	120.8	112.6	71.3	46.6	
<i>Large corporations</i>	264.1	67.5	77.6	73.0	46.2	29.4	
<i>SMEs*</i>	141.7	37.6	43.2	39.6	25.0	17.2	
<i>Selected sectors</i>							
Agriculture, hunting, forestry and fishing	14.1	3.6	4.2	3.9	2.5	2.2	
Mining and quarrying	2.0	0.7	0.5	0.5	0.3	0.3	
Manufacturing	134.9	35.0	40.5	34.9	22.1	11.2	
Construction	32.6	8.3	8.7	8.0	5.1	4.8	
Real estates	12.3	3.6	4.0	4.7	3.0	3.5	
Electricity, gas and water supply	1.3	0.4	0.3	1.0	0.6	0.6	
Wholesale, retail, restaurants and hotels	91.5	25.4	31.6	27.5	17.4	8.5	
Transport, storage and communication	32.1	5.6	7.9	3.3	2.1	3.2	
Finance, insurance and business services	45.7	11.9	13.3	15.0	9.5	6.6	
Households	169.5	44.9	47.3	45.4	28.7	53.4	
Purchase of residential properties	39.9	11.1	12.2	12.3	7.8	25.4	
Consumption credit	109.4	29.2	29.9	27.8	17.6	21.4	
<i>Of which:</i>							
<i>Credit cards</i>	57.9	15.4	14.8	15.2	9.6	3.4	
<i>Purchase of passenger cars</i>	27.8	7.4	9.0	6.8	4.3	13.7	
Others	20.2	4.6	5.2	5.2	3.3	6.5	
Total	575.3	150.0	168.1	157.9	100.0	100.0	

* Include loans to individual businesses.

Source: Bank Negara Malaysia

During the quarter under review, MGS yields remained on a downward trend as investors' demand for risk-free assets was strong. Furthermore, indications of easing inflationary pressures and increasing concerns over the slowdown in economic growth heightened expectations for a reduction in the OPR. After Bank Negara Malaysia reduced the OPR in November 2008, MGS yields across all maturities eased further. Towards year-end, MGS yields continued to decline on expectations for further interest rate cuts. As at end-December 2008, the 3, 5 and 10-year MGS fell by 96, 106 and 137 basis points respectively.

KLCI declined in the fourth quarter

In the fourth quarter of 2008, the KLCI declined in line with other regional markets. The weak performance of the local market was due to concerns over the depth of the global recession and expectations for weak domestic corporate earnings. The decline, however, was mitigated somewhat by improvements in market sentiments following policy actions by governments to support growth. The KLCI ended the fourth quarter lower at 876.8 (3Q 08: 1,018.7). Market capitalisation declined to RM663.8 billion (3Q 08: RM770.5 billion) but trading activity increased to a daily average turnover of 610.1 million units (3Q 08: 437 million units).

On 24 February 2009, the KLCI closed higher at 894.1 (since end-2008: +2.0%), with market capitalisation higher at RM670.2 billion (since end-2008: +1%).

The ringgit broadly depreciated against the US dollar

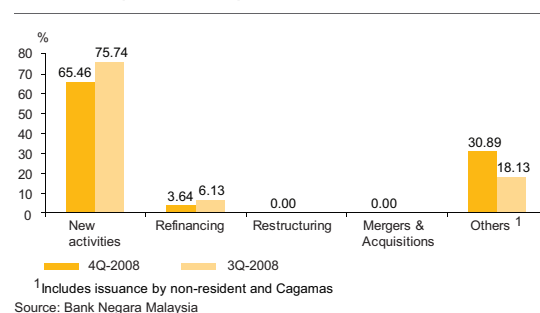
The ringgit depreciated against the US dollar during the fourth quarter following continued global de-leveraging activities. The ringgit weakened to RM3.6375 against the US dollar on 5 December 2008, representing a 13.9% decline from the 23 April 2008 peak of RM3.1315. Towards the end of the year, the ringgit experienced some recovery with the ringgit-US dollar exchange rate at 3.4640, as at 31 December 2008, 4.5% lower than the end-2007 level. Against other major currencies during the fourth quarter, the ringgit was stronger against the pound sterling by 24.5% and by 1.8% against the euro amid growing concerns over deteriorating economic conditions in the UK and euro area. The ringgit also appreciated against most regional currencies in the range of 0.3% to 15.9% during the period. The exception was the Chinese renminbi, against which the ringgit depreciated by 0.5%.

Funds Raised in the Capital Market

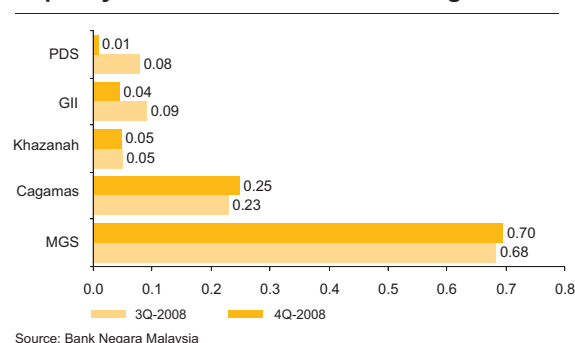
	2007		2008	
	4Q	Year	3Q	4Q
	RM million			
By Public Sector	(5,946)	25,178	680	13,859
Government Securities, net	(5,552)	27,187	1,688	14,865
Malaysian Government Securities	14,048	43,187	11,337	11,965
Government Investment Issues	-	10,000	3,500	7,500
Less: Redemptions	19,600	26,000	13,149	4,600
Khazanah Bonds, net	-	(496)	(1,000)	(1,000)
Merdeka Savings Bond, net	(394)	(1,513)	(8)	(6)
By Private Sector	6,513	20,300	5,915	451
Shares	3,819	7,126	2,201	222
Debt securities, net	2,694	13,174	3,714	229
Private Debt Securities	28,746	67,606	11,001	8,953
Cagamas	-	1,750	-	-
Less: Redemptions	26,052	56,182	7,287	8,724
Total	567	45,478	6,595	14,310

Source: Bank Negara Malaysia

Private Debt Securities Issued by Purpose (% of total)

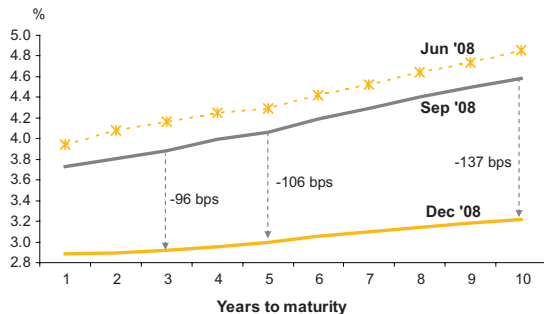


Liquidity Ratio: Turnover / Outstanding



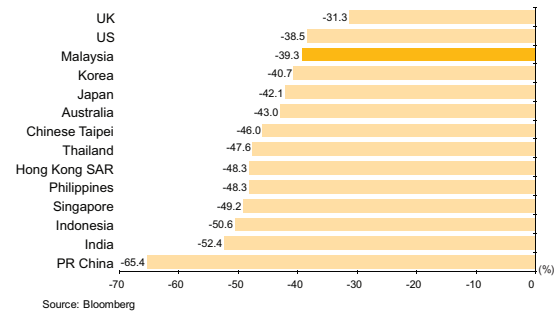
During the period of 1 January to 24 February 2009, the ringgit depreciated against the US dollar by 5.6%, the pound sterling by 6.4% and the Japanese yen by 0.7%, but appreciated against the euro by 4.5%. The ringgit depreciated against regional currencies in the range of 0.2% to 5.6%, with the exception of the Korean won, the Indonesian rupiah and the Singapore dollar, against which the ringgit appreciated by 13.2%, 3% and 0.4% respectively.

Trend in MGS Yields



Source: Bank Negara Malaysia

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



Source: Bloomberg

During the period of 1 January to 24 February 2009, the ringgit depreciated against the US dollar (-5.6%), the pound sterling (-6.4%) and the Japanese yen (-0.7%), but appreciated against the euro (4.5%). The ringgit depreciated

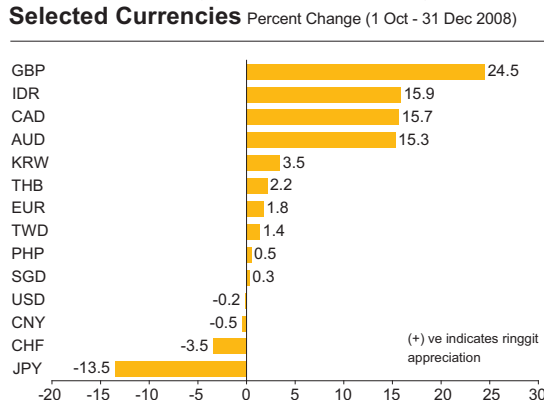
against regional currencies in the range of 0.2% to 5.6%, with the exception of the Korean won, the Indonesian rupiah and the Singapore dollar, against which the ringgit appreciated by 13.2%, 3% and 0.4% respectively.

Bursa Malaysia: Turnover of Corporate Securities

	2007				2008					
	4Q		Year		3Q		4Q		Year	
	million units	RM million	million units	RM million	million units	RM million	million units	RM million	million units	RM million
Turnover	78,648	117,720	383,991	581,733	27,965	57,172	36,605	54,438	154,459	313,083
Of which:										
Main Board	50,667	106,134	271,381	520,787	23,195	55,867	31,273	53,316	119,303	301,289
Of which:										
Consumer Products	1,752	4,777	7,844	20,411	903	2,874	946	2,478	3,671	11,973
Industrial Products	4,906	8,213	29,719	45,069	3,507	4,981	7,609	5,450	17,865	23,704
Construction	3,486	9,748	22,812	57,456	2,995	5,855	3,076	3,967	14,119	30,070
Trading/Services	15,545	38,069	72,457	178,208	6,950	19,311	9,327	20,377	35,826	106,698
Finance	3,728	17,445	23,640	90,048	1,812	9,155	2,652	10,190	10,846	59,459
Properties	7,300	7,814	50,259	48,685	2,500	1,802	3,044	1,805	12,832	12,076
Plantations	2,177	9,658	7,526	37,222	1,723	9,166	2,011	6,284	7,524	39,238
Infrastructure	1,408	4,694	6,284	15,390	511	1,912	787	2,170	3,398	10,713
Second Board	7,254	4,707	34,776	23,887	1,983	919	2,276	739	10,761	6,521
Mesdaq	6,139	3,050	43,276	23,842	1,412	331	1,686	294	11,239	3,921

Source: Bursa Malaysia

Summary of Ringgit Performance Against Selected Currencies



Bursa Malaysia: Selected Market Indicators

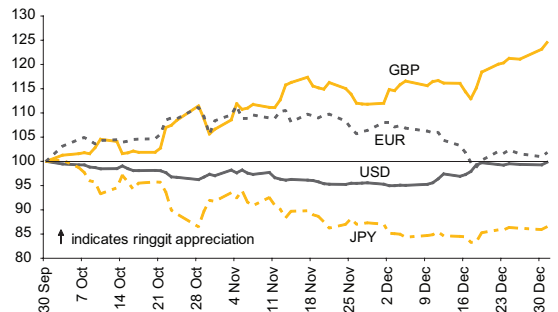
	As at end				
	2007		2008		
	4Q	Year	3Q	4Q	Year
Price Indices					
Composite	1,445.0	1,445.0	1,018.7	876.8	876.8
FBM30 ¹	9,343.7	9,343.7	6,577.7	5,637.7	5,637.7
FBMEMAS ²	9,810.8	9,810.8	6,755.9	5,726.5	5,726.5
FTSE Second Board	6,732.4	6,732.4	4,978.8	4,007.3	4,007.3
FTSE Mesdaq	6,109.2	6,109.2	3,968.3	3,333.6	3,333.6
Average daily turnover					
Volume (million units)	1,268.5	1,548.4	437.0	610.1	630.4
Value (RM million)	1,898.7	2,345.7	893.3	907.3	1,277.9
Market capitalisation (RM billion)	1,106.2	1,106.2	770.5	663.8	663.8
No. of companies listed	987	987	981	977	977

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

Source: Bursa Malaysia

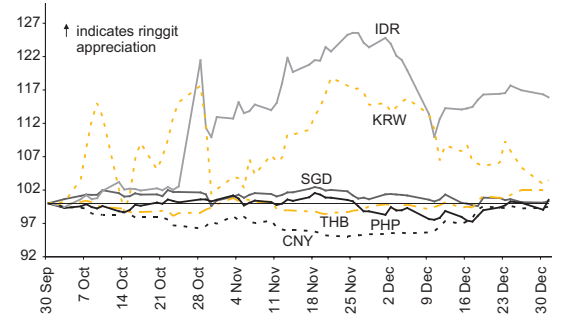
Ringgit Performance Against Major Currencies

Index
(End- Sep 2008 = 100)



Ringgit Performance Against Regional Currencies

Index
(End- Sep 2008 = 100)



Performance of Ringgit Against Selected Currencies

RM per foreign currency	As at end				% change since*		
	21 Jul 05	4Q 07	3Q 08	4Q 08	21 Jul 05	4Q 07	3Q 08
US dollar	3.8000	3.3065	3.4575	3.4640	9.7	-4.5	-0.2
Euro	4.6212	4.8756	4.9636	4.8759	-5.2	-0.0	1.8
Pound sterling	6.6270	6.6070	6.2254	4.9989	32.6	32.2	24.5
100 Japanese yen	3.3745	2.9534	3.3154	3.8327	-12.0	-22.9	-13.5
Singapore dollar	2.2570	2.2938	2.4153	2.4070	-6.2	-4.7	0.3
100 Thai baht	9.0681	9.8159	10.154	9.9398	-8.8	-1.2	2.2
100 Philippine peso	6.8131	8.0158	7.3159	7.2774	-6.4	10.1	0.5
100 Indonesian rupiah	0.0386	0.0352	0.0367	0.0316	22.0	11.3	15.9
100 Korean won	0.3665	0.3532	0.2846	0.2750	33.3	28.4	3.5
Chinese renminbi	0.4591	0.4527	0.5051	0.5076	-9.6	-10.8	-0.5

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

Source: Bank Negara Malaysia

DEVELOPMENTS IN THE BANKING SECTOR

The banking sector remained resilient with key financial soundness indicators at healthy levels. With a sound financial position and ample liquidity, the banking system remains well-positioned to weather the challenging environment envisaged in 2009, whilst continuing its intermediation role effectively to support the financial needs of the economy.

Capitalisation level remained high

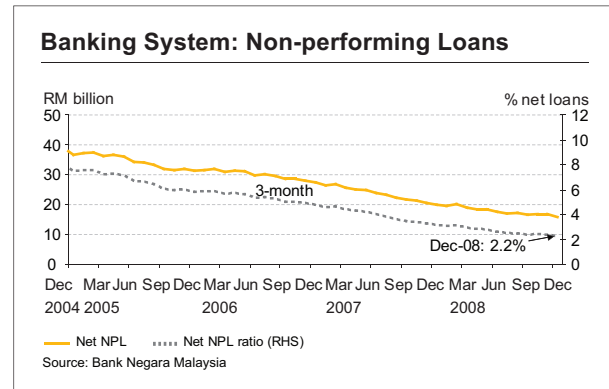
As at end-December 2008, the banking system's risk-weighted capital ratio (RWCR) and core capital ratio (CCR) was at 12.7% and 10.6% respectively. Capital base moderated marginally by 0.3%, mainly on account of higher investments in subsidiary companies. Nevertheless, excess capital above the minimum 8% requirement remained high at RM38.8 billion at end-2008.

	2007	2008			
	4Q	1Q	2Q	3Q	4Q
Capital					
CCR (%)	10.2	10.4	10.8	10.6	10.6
RWCR (%)	13.2	13.3	13.6	13.0	12.7

Source: Bank Negara Malaysia

Profitability remained high amidst challenging environment

The banking system recorded a pre-tax profit (PBT) of RM5.1 billion (3Q 08: RM 4.0 billion) during the quarter supported by better performance of treasury-related activities and improved interest income from intermediation activity. The annualised average returns on assets and equity remained stable at 1.5% (3Q 08: 1.5%) and 18.6% (3Q 08: 18.7%) respectively.



Level of non-performing loans continued to decline

The quality of banking system loan portfolio recorded further improvement during the quarter. Net NPLs declined by 5.0% to RM15.8 billion (3Q 08: RM16.6 billion) to account for 2.2% of total net loans as at end-2008 (3Q 08: 2.4%).

**Islamic Financial Services Board and
Institute of International Finance Conference:
'Enhancing the Resilience and Stability of the Islamic Financial System'
Kuala Lumpur, 20 November 2008**

Keynote Address by

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

It is my honour and great pleasure to speak before this distinguished audience, at this conference, jointly organised by the Islamic Financial Services Board and the Institute of International Finance. At a time when the international financial system is currently in turmoil, this forum provides an important opportunity to enhance our understanding of the developments, the issues that have come to the forefront and the implications it has for achieving stability in the global financial system.

Our specific interest today is to consider these issues in the context of the Islamic financial system, in particular, whether Islamic finance as a form of financial intermediation could be vulnerable to such risks of instability. In addition, what are the possible steps that might be taken to strengthen the resilience and stability of the Islamic financial system. The collaboration between the IFSB and the IIF in creating this platform is most timely. The global challenges posed by current international financial crisis necessitates global engagement. Given its far reaching repercussions, the strategic solutions need to be global in nature involving both reforms and measures to restore soundness and stability of the international financial system.

My remarks today will focus on the implications for the strategic direction of the Islamic financial industry taking into consideration the lessons learned from such financial turbulence including the current crisis. As Islamic finance becomes an integral part of the international financial system, it will be increasingly tested by such developments. History has shown that the world will continue to be plagued by such crises. The key for the Islamic financial industry is therefore to ensure that it would not be a source of such financial instability and is able to achieve a level of resilience that would ensure its sustainability.

Lessons Learned from Systemic Banking Crisis

The world has experienced more than 124 distinct banking crises in the recent 27 years.¹ While the triggering factors that precipitated financial crisis have been different, for most, it resulted in a general loss of confidence and a downward spiral in asset prices.

Such a crisis was experienced in the Asian region just over ten years ago. Following the lessons that were learnt from this experience, Asia has emerged in a better position to manage the spill over effects of the current financial turmoil. The key elements in the efforts have been the strengthening of the foundations that accord the resilience to withstand shocks to the system and that will ensure sustainability through episodes of such turmoil.

There are several similarities in the current financial crisis and the Asian financial crisis. In both cases, the crises followed a period of strong growth, rapid credit expansion and sharply rising asset prices. Prior to the Asian crisis, there was indiscriminate lending to the corporate sector. Investment activity was excessive, with the ratio of investment to GDP exceeding 35% for many economies in the region. The sub-prime crisis similarly originated from imprudent lending practices. The low interest rate environment also accentuated the build up of the excesses and rising asset values. In Asia, domestic credit increased to unsustainable levels, reaching 180% of GDP during this period. In the United States, it had increased close to 240% in 2007. The excessive leveraging and increased risk taking reinforced the formation of asset bubbles.

¹ L. Laevan and F. Valencia, "Systemic Banking Crises: A New Database", (Sept 2008) International Working Paper of the International Monetary Fund, WP/08/224

In both cases, there was also abundant liquidity. Both Asia and the United States experienced surges of capital inflows. This was reinforced by favourable sovereign ratings in Asia and the strong ratings for the securitized instruments in the US. The eruption of the crisis set off the reversal of these trends. There was also a failure to recognise that in a highly integrated international financial system, it meant that a crisis that originate in one part of the financial system not only would have an impact on other parts of the system but it could have far reaching implications on other jurisdictions.

A further similarity relates to the lack of capacity to manage the increased risks associated with the transformation of the financial sector. For Asia, the increased liberalisation was not accompanied by the development of the necessary domestic financial infrastructure and the capacity to manage the increased risks and vulnerabilities associated with the liberalisation. In the current crisis, financial innovation occurred at a pace that outstripped the ability to manage the associated risks with such innovations. There was excessive risk taking and a lack of transparency and disclosure in the financial transactions. The complex structured instruments and securitisation process resulted in multi-layered structuring of financial products which were not supported by enhancements to governance processes and the risk management infrastructures and practices. This resulted in an underestimation of the risks involved and the capital buffers that were necessary.

The ensuing turmoil in the financial markets that followed was increasing illiquidity in the financial markets and the subsequent breakdown in the functioning of the markets. As this continued, it has translated into stress and insolvencies in the financial sector. In both crises, this precipitated a sudden pull back in bank lending. The ensuing credit crunch magnified further the damaging impact on the economy.

In Asia, the economic contraction was severe in the range of minus 7% to 13%. In the current financial crisis, however, the spillover impact of the effects on the economy has yet to be fully felt. In the Asian financial crisis, it ran its full course with the rapid price adjustments

in most asset markets taking place within a period of just over a year. In Asia, there was limited potential to reduce interest rates in an environment that was vulnerable to capital outflows. The focus of policy in Asia was therefore on the resolution of the banking sector and to restore the functioning of the intermediation process. In most of the crisis affected economies in Asia, this strategy produced positive results and growth resumed within twelve to eighteen months.

Financial Crisis and Islamic Finance

In the midst of the unfolding of the global financial crisis, it is useful to review the foundation and structures of the Islamic financial system to assess its resilience in withstanding the impact of the current and future crises. In taking into account the dynamics of the crisis and the potential implications for Islamic finance, two important dimensions are key in undertaking the assessment.

The **first key dimension** highlights the inherent ability of Islamic financial system to deal with the test of such crisis. Islamic finance is well-supported by two essential features which serve as pillars to Islamic financial transactions. Firstly, Islamic finance encourages business and trade activities that generate legitimate profits, subject to an explicit requirement of materiality and validity of the transaction. This requirement ensures that the funds are channelled into real financial business activities, reinforcing a close link between financial and productive flows. This reduces the Islamic financial system from over exposure to risks associated with excessive leveraging and imprudent risk taking. In Islamic financial transactions, money is not a commodity, but a medium of exchange, a store of value and a unit of measurement. Money represents purchasing power and cannot be utilised to increase the purchasing power without any productive activity.

Secondly, Islamic finance encourages business transactions on a mutual risk sharing basis. The practice of risk sharing provides the impetus for the Islamic financial institutions to conduct the appropriate due diligence and maintain the explicit requirements

for disclosure and transparency. These requirements thus serve to promote the adoption of sound risk management practices by the Islamic financial institutions.

By embracing these essential features and the objectives of Shariah in its entirety and by exemplifying the true practice of Islamic finance as required by the principles of Shariah, the resilience of the Islamic financial system is strengthened. It is therefore paramount that Islamic financial professionals, practitioners, scholars and regulators fully understand the inherent requirements of Islamic finance, which are in fact consistent with the international best practices and standards in the conventional financial services industry. It is these very elements of Islamic finance that provides an additional in-built mechanism that enhances its prospects for soundness and stability.

The **second key dimension** relates to potential risks for Islamic finance in a crisis environment. This could arise when the economic environment and the conditions in the financial markets turn adverse. The increased globalisation of Islamic finance and its greater integration with the international financial system increases the exposure of the system to contagion effect from such developments. In the dynamics of a financial crisis in the conventional financial system, this would be referred to as the second round effects. The first round effects is when developments within the financial system triggers the financial crisis which in turn impacts the real economy. The second round effects is when the resulting slower growth causes further strain to the financial sector.

The experience has shown that when such crisis is not contained, the consequent deterioration in economic conditions results in a worsening of the financial crisis. For this reason, resolution has to take place quickly. For Malaysia, in the 1997-98 crisis, every effort was taken to give attention to financial sector resolution so as to prevent the spiral that could have set in as economic activity became affected by the financial crisis.

In this indirect manner, Islamic finance would be affected by such financial turmoil. Slower economic growth and the reduction in the

global liquidity would affect those institutions that are heavily reliant on a business model that focuses on real estate and asset finance. Islamic financial institutions would also be exposed to increased inventory risk due to the increased volatility and the reduction in asset prices. Islamic financial institutions with a high proportion of their businesses in profit sharing business (Mudharabah and Musyarakah) may be exposed to losses due to equity investment risk, possibly by the inability of the enterprises in generating the expected returns. The absence of an Islamic money market infrastructure would also expose the Islamic financial system to higher liquidity risks.

Strategies to Strengthen the Resilience of Islamic Financial System

As innovation of Islamic financial products and services intensifies and as Islamic finance becomes more integrated with the international financial system, it becomes imperative that the foundations upon which Islamic finance has been built remains intact. This will be the key to sustaining the resilience of the Islamic financial system in this more challenging international financial environment.

Key to this is to embrace Shariah-based innovation in the development of Islamic financial products. In a highly globalised financial market, innovation has been a key differentiating factor to remain competitive. The current turmoil has however, highlighted that highly complex, unbridled innovation can become highly destabilising resulting in major disruptions in a financial system. It is therefore important for financial innovation to have clear Shariah objectives and adhere to the requisite principles of Shariah. In this manner, Shariah-based innovation would contribute towards Islamic financial products that have distinct value propositions with in-built strengths arising from the essential features of Shariah.

To achieve this objective, it is important to have strong initiatives that promote Shariah-based innovation in Islamic finance. In Malaysia, several steps have been taken. The establishment of the International Shariah Research Academy for Islamic Finance (ISRA) aims to engage in applied research on dynamic

Shariah-centric innovation. ISRA can provide a global platform for greater global engagement and research with the focus on innovation.

In addition, the Central Bank has also embarked on the initiative to develop the Shariah Parameters to promote more consistent application of Islamic financial contracts. This initiative aims to determine the essential features of Islamic financial products derived from underlying key Shariah contracts. These features will serve as a guide for the application of the Shariah contracts for the Islamic financial products.

The second strategy is to raise the bar in the status of the Islamic financial infrastructure that supports the risk management and governance of Islamic financial institutions.

To ensure sustainability of the resilience of Islamic finance, it is important to have the comprehensive enabling infrastructure that allows for the management of the risks that are peculiar to Islamic finance. There is a need for Islamic financial system to have the capital requirements, effective risk management and strong governance that are fully equipped to manage the risks that are specific to Islamic financial transactions. It is also important for the institutions to spread the risks by having prudent asset allocation based on different Islamic contracts so as to ensure a sustainable revenue stream and to ensure the institutions are in a position to absorb the extreme circumstances that occur during a crisis.

In the case of Malaysia, an additional capital requirement is required to cushion inventory risks of underlying assets and to cover the potential equity position risks that are embedded within the partnership contracts. This is also reinforced by the requirement on the appointment of board representatives in the invested entities under the partnership contracts so as to serve as a safeguard for the interest of the Islamic financial institution thereby allowing for continuous monitoring and surveillance. Islamic financial institutions are also allowed to transfer the risk to investment account holders under Mudharabah, i.e. profit sharing and loss bearing contract, if the institution

can demonstrate the appropriate disclosure and governance practices that would ensure an effective risk transfer. Islamic banks are also permitted to set aside a portion of income derived from assets funded by Mudharabah contracts, in the form of profit equalization reserves (PER) to sustain stable and competitive returns. Several of these requirements are based on the international standards that have been issued by IFSB. The implementation of IFSB standards across jurisdictions will be key in the continued robust expansion of Islamic finance.

While the above measures facilitate the managing of risks peculiar to Islamic finance, the legal, regulatory and supervisory infrastructure also needs to keep abreast with the evolution and rapid transformation taking place in the industry. As part of this infrastructure, there needs to be an integrated crisis management framework to ensure that any emerging crisis in the Islamic financial system will be promptly managed. Such efforts, among others need to involve three basic aspects. This includes having the mechanism and vehicle to preserve short-term liquidity, to remove troubled assets from the balance sheets of financial institutions and to recapitalise Islamic financial institutions.

In the case of Malaysia, this infrastructure has been put in place. The Central Bank has a range of Islamic financial instruments to manage liquidity in the financial system. This is supported by a well developed Islamic money market. In addition, the financial safety net framework in Malaysia encompasses the lender of last resort facility and a comprehensive deposit insurance system that provides coverage for both conventional and Islamic deposits. The Deposit Insurance Corporation has also been given sufficient statutory powers to ensure a prompt, effective and least cost resolution to safeguard the stability of the Islamic financial system. This entails among others, the regulatory powers and mandate to ensure expedient resolution of financial institutions in distress. Our supervisory oversight also subjects the Islamic financial institutions to periodical stress testing to assess whether the institutions would be able to cope in extreme conditions.

Global ramifications of the crisis also calls for more concerted efforts at the international level to avert an escalation of the scale of a crisis. Central to this is to have coordinated initiatives, by having in place on-going assessments of any vulnerabilities in the Islamic financial system so as to avoid crisis. As part of this, the close cooperation of the central banks would enable a swift response if it is required.

Thirdly is to assimilate the Shariah values in the realisation of benefit (Masalih) to the relevant stakeholders. Islamic finance industry may, by according attention to the preservation of good relationship with the customers and relevant stakeholders, avoid extreme solutions when severe deterioration has taken place. Consistent with this is the principle in Islamic finance to promote justice, fairness and shared responsibility. The focus of Islamic finance thus transcends beyond just the pursuit of growth and monetary performance by emphasising ethical market conduct practices. Central to this is the adoption of a comprehensive consumer protection framework.

Conclusion

In shaping the robust growth of Islamic finance, the strategic direction of the industry moving forward needs to be accompanied by the efficient implementation of the legal, regulatory and supervisory regime, including having in place a crisis prevention and management framework. While recognising the strengths of Islamic finance and the opportunities it presents, key to this is ensuring the essential features of Islamic finance are preserved so as to retain its inherent resilience and stability.

The robust growth of Islamic finance has been from the significant interest from both the Muslim and non-Muslim communities. This would not occur if Islamic finance was not able to meet the growing and differentiated financial requirements, if it were not an efficient form of financial intermediation and if it were not competitive. As a growing part of the international financial system that has become increasingly challenging, our task will be to build on the inherent strengths of Islamic finance and to continue to strengthen the supporting structures so as to ensure that Islamic finance will contribute to the overall stability of the global financial system.

**State Street Islamic Finance Congress 2008:
'Islamic Finance: A Global Growth Opportunity Amidst a
Challenging Environment'
Boston, United States of America, 6 October 2008**

Keynote Address by

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

This decade has witnessed the rapid evolution of Islamic finance. This has resulted in the dramatic transformation of the industry, from being focused on retail financing to providing an extensive spectrum of financial products and services, from being focused on the Muslim community to having an extended reach that serves the non-Muslim community, from being governed by conventional regulatory and accounting standards to having promulgated its own standards and finally from being domestic centric to becoming increasingly internationalised. The Islamic financial services industry has during this decade transitioned into a dynamic, fast growing and competitive form of financial intermediation servicing the global community.

It is my honour and great pleasure to be here in Boston to participate in this inaugural State Street Islamic Finance Congress. With the recent evolution and expansion in Islamic finance, it has now emerged as a viable new asset class for investors and a competitive form of financing for businesses. It has therefore, not only allowed for the further diversification of risks, but, the resulting higher level of foreign participation and the increased cross border flows has not only strengthened international financial inter linkages between nations but also contributed to the more efficient international allocation of resources across borders.

Intrinsic Strength of Islamic Finance

Islamic finance has, thus far, remained positive, despite the current challenging global financial environment. The strengths in Islamic finance are derived from the Shariah principles, the key pillar of Islamic

finance that has contributed towards its overall stability and resilience. The Shariah injunctions require that the financial transactions be accompanied by an underlying productive activity thus giving rise to a close link between financial and productive flows.

In addition, under the risk sharing arrangement, the Islamic financial institution will share the profit or loss incurred by the entrepreneur. Under this arrangement, there is an explicit risk sharing by the financier and the customer and the real activity is expected to generate sufficient wealth to compensate for the risks. This arrangement, thus, entails the appropriate due diligence and the integration of the risks associated with the real investment activity into the financial transactions. In addition, the Shariah principles also prohibit excessive leverage and speculative financial activities thus insulating the parties involved from excessive risks exposures.

The intrinsic principle of profit and risk sharing thus provides an in-built check and balance to the Islamic financial transactions. Explicit in this arrangement is the element of risk management and governance practices. Hence, it is a modality in which there is strong explicit emphasis on the economic viability of the underlying assets and on good governance, ethics and transparency.

A demand-driven industry with growing potential

This decade has seen the global Islamic finance industry evolve from being faith-based to a business driven industry for all communities. Its significant similarities to the principles in ethical finance and socially responsible investment has been a further

factor that has drawn interest in Islamic Finance. Islamic finance does not only involve the avoidance of *riba* (usury) but also extends to issues relating to ethical values, such as fair trade and environmental protection. This has prompted participation from conventional global players in Islamic financial activities and in the acquisition of strategic stakes in Islamic financial institutions.

There is also a growing number of established international financial centres such as London, Tokyo, Hong Kong and Singapore that have initiated plans for the integration of Islamic finance into their financial systems. Islamic finance has now become one of the fastest growing segments in the global financial system. The total Islamic assets under management by Islamic banks and conventional banks offering Islamic banking services is reported to exceed USD500 billion. This growth has also been in the other major components of the Islamic financial system. Islamic mutual funds are estimated to be about USD300 billion, while global *takaful* or Shariah-compliant insurance contributions are estimated to be about USD5 billion.

Strengthening the International Infrastructure

Integral to the efforts in the development of Islamic finance has been the development of the supporting international Islamic financial architecture. 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) established in 1990 has been key to ensuring the soundness and stability of the Islamic financial system.

The IFSB and AAOIFI have had an important role in the harmonisation of prudential and accounting standards across the different jurisdictions. They are also instrumental in instituting international best practices in the global development of Islamic finance. The Islamic financial institutions are also subject to the requirements on anti-money laundering and anti-terrorist financing.

Opportunities through greater international financial integration

The globalisation of Islamic finance has gained significant momentum in this recent five years. 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 financial institutions in new jurisdictions and more recently, the increased number of Islamic financial institutions which have shareholders from multiple jurisdictions.

Greater financial integration has essentially been facilitated by the more rapid pace of liberalisation that has been supported by the progress that has been achieved in the development of the international Islamic financial infrastructure. This trend has also been prompted by the need for greater diversification of risks in the management of funds. In the current international financial environment, this trend has become more pronounced prompting investors to consider other asset classes and markets that provide stability. Thus far, the global financial crisis has had limited direct effects on Islamic finance. While Islamic finance by its very nature only engages in transactions that have underlying tangible productive activities, the slower overall growth and the increased uncertainties have affected pricing and activity in certain market segments. However, this in part reflects the shift in activity from the financial markets to the Islamic financial institutions.

The scope of Islamic financial business has now expanded 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. This market has expanded by an annual growth rate of 40%. The year 2007 saw an exceptional growth of the global *sukuk* market which expanded by more than 70%. New issues during the year reached a record high to about

US\$47 billion and the outstanding global sukuk market has now surpassed the US\$100 billion mark. Up until August this year, it has held its ground with a total global issuance now exceeding US\$14 billion, and is expected to exceed USD200 billion in 2010. This growth is spurred in part by the growing funding requirements in emerging market economies, in particular, in Asia and the Middle East. This is reinforced by the continued confidence of investors in the Islamic financial instruments.

Malaysia's Islamic Finance Journey

Let me now turn to Malaysia's journey in the development in Islamic finance. Islamic finance in Malaysia first started as a strategy for greater financial inclusion, so as to have a greater outreach to the underserved segment of society to basic banking and insurance products that are compatible with Shariah principles. After three decades, the Islamic financial industry in Malaysia has evolved as an integral and competitive component of the overall financial system that operates in parallel with the conventional financial system.

The Malaysian Islamic financial system is founded on three major strategies. **Firstly**, the Islamic financial system has been evolved as a comprehensive financial system that is diversified in terms of its institutions, markets and players. The Islamic financial system comprises the Islamic banking institutions, the takaful industry, the non-banking institutions and the Islamic money and capital markets. The supporting financial infrastructure includes the robust regulatory and supervisory framework that is reinforced by the legal and Shariah framework, the payment and settlement systems and the mechanism for the liquidity operations by the Central Bank.

The assets of the Islamic banking system now comprise 16% of the market, while the takaful sector has garnered 7% market share. Significant progress been achieved in particular in the Islamic capital market where the outstanding amount of Islamic private securities amounted to USD79 billion or 54.3% of the total outstanding private securities in the market. The number of Shariah-based unit trust funds have also increased to 136

with a net asset value of over USD5.2 billion while 85% of the listed Malaysian stocks are Shariah-approved counters.

The second strategy is to accord greater emphasis on the enabling environment for increased innovation in the Islamic financial industry. The product range in Islamic finance has now expanded into a broad spectrum of innovative instruments, including investment and equity linked products based on musyarakah, mudarabah and ijarah. These products are competitive both in terms of product structure and pricing. The enhanced depth of the Islamic financial markets, in particular, the sukuk market, has increased the attractiveness of the Islamic financial instruments as an asset class for investment.

The drive for innovation has been supported by the investment in human capital development. A sufficient pool of the talent and expertise has been key to the development of the Islamic financial hub in Malaysia. The International Centre for Education in Islamic Finance (INCEIF) was established in 2006. INCEIF which has an international faculty and students from more than 40 countries is focused on programmes for Islamic finance professionals and specialists in Islamic finance. The first group of students for the Chartered Islamic Finance Professional qualification, CIFP, offered by INCEIF, is expected to graduate at the end of this year after completing a three year programme that includes an internship with an Islamic financial institution. INCEIF also offers a Masters and PhD Programme in Islamic finance.

To promote research in Islamic finance, the International Shariah Research Academy (ISRA) was established this year to conduct applied Shariah research on the contemporary Islamic finance issues. ISRA also provides a platform that promotes active engagement and dialogue among global Shariah scholars that promote mutual respect in Shariah and the convergence of views from different jurisdictions in the global Islamic financial system.

The third strategy is to promote greater financial integration with the global Islamic financial system. The Malaysian Islamic financial system has also been progressively liberalised to allow for increased foreign entry and participation in our financial system, thus facilitating greater

cross border flows and thus strengthening the international financial inter-linkages. This has taken the form of issuance of new licences and increasing foreign participation in both Islamic banks and takaful companies to 49%. New licences were also issued to foreign fund managers and foreign stockbrokers. In this new phase of development for Islamic finance, Malaysia as an international Islamic financial hub, has increasingly become a meeting place for businesses from different parts of the world that need to raise funds and for investors that have surplus funds for investment.

Islamic Finance Going Forward

There is now a strong and growing demand for Islamic financial products in the global market, far exceeding the current availability of financial products and services being provided by the Islamic financial institutions. Going forward, there is therefore tremendous upside potential for Islamic finance.

As the pace of development of the Islamic financial services industry accelerates, the increasingly more complex and challenging environment will continue to shape the advancement of the industry. Central to this will be the expansion of the business parameters and innovative product offerings. For this, there is increased investment in research and development to yield new instruments and structures to meet the changing requirements of the international community. An area of focus, in particular, is related to the development of mechanisms for risk mitigation and liquidity management. Of importance, are the solutions needed to converge the market requirements and the Shariah compliance.

Increased innovation also calls for greater emphasis on the implementation of best practices and higher standard of risk management. Vital to this is the implementation of the prudential standards promulgated by the IFSB. There is also a need to leverage more on IT applications and the strengthening of management capabilities of the Islamic financial institutions. Going forward, with the increased awareness and understanding of Islamic finance, the role of market discipline will become increasingly important in driving Islamic financial institutions towards ensuring Shariah

compliance in the operations, in improving operational efficiency and in instituting sound and dynamic risk management practices.

The forces of innovation also raise a number of issues concerning the 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 now prompted increased international dialogue among the Shariah scholars from the different parts of the world. It is the closer linkages between the global Islamic financial markets and the increased platforms for greater engagement on Shariah issues that will contribute towards promoting an increased common understanding and mutual acceptance on the rules, standards and Shariah views, and for convergence to occur. This would evolve global Shariah standards for the Islamic financial industry.

As Islamic finance continues internationalise with expanding scale, there will be greater financial intermediation linkages among the East Asian, West Asian, and the Middle East regions – creating the “New Silk Road”. While this New Silk Road of financial flows is enhancing connectivity between Asia and the Middle East, both regions have, as in the case of the old Silk Road, extended the New Silk Road to the rest of the world. Global investors and the international financial community have already drawn benefits from the increased diversification of investment activity to the two regions. The expansion of the interlinkages of intermediation to and among these regions would in turn contribute towards a more efficient allocation of capital in the global financial system.

Closing Remarks

Against a backdrop of an increasingly uncertain global environment, Islamic finance, as a form of financial intermediation in the international financial system, has continued to be viable and competitive. In the coming years, the greater global participation in this developmental process, both directly and indirectly, would enhance the potential role that Islamic finance would have in contributing towards greater global financial stability in the international financial system.

CALENDAR OF EVENTS

October – December 2008

6 October 2008

In her keynote address at a State Street Islamic Finance Congress 2008 in Boston, USA, Governor Dr. Zeti said Islamic finance has become more viable and competitive amidst the global uncertainties. She added that globalisation of Islamic finance has gained significant momentum in recent years and demand for Islamic financial products in the global market exceeds the current availability of the products and services provided by the Islamic finance institutions. Going forward, there is therefore tremendous upside potential for Islamic finance.

14 October 2008

The Bank, in a press statement, stated that Malaysian financial institutions remain resilient despite increased volatility in global financial markets. Financial institutions in the country, equipped with adequate capital and liquidity buffers, have negligible exposure to both sub-prime related securities and to the affected financial institutions of other nations. More than 90% of total assets of the country's banks and insurance companies are in ringgit denominated assets. In addition, all foreign financial institutions in Malaysia are locally incorporated and have a high level of capital that is committed to support their domestic operations. The central bank, having a fully-developed supervisory and surveillance system, will take appropriate action to safeguard the soundness of the financial system should the need arise.

16 October 2008

The Bank and Ministry of Finance Malaysia jointly announced that all ringgit and foreign currency deposits with commercial, Islamic and investment banks and deposit-taking development financial institutions regulated by the Bank are fully guaranteed by the government through Perbadanan Insurans Deposit Malaysia (PIDM) with immediate effect until December 2010. The guarantee extends to all domestic and locally incorporated foreign banking institutions. Access to the Bank's liquidity facility was also extended to insurance companies and takaful operators, regulated and supervised by the Bank.

24 October 2008

The Bank's Monetary Policy Committee (MPC) decided to leave the Overnight Policy Rate (OPR) unchanged at 3.50%. The Bank noted that since the last MPC meeting in August, the global economic situation has deteriorated considerably and the international financial turmoil has yet to stabilise. The greater focus of policymakers would be towards avoiding sharp global economic downturn. At the subsequent meeting on 24 November, the MPC cut the OPR by 25 basis point to 3.25%. Given the heightened downside risks to growth and diminishing inflationary pressures, the reduction in the OPR was a pre-emptive measure aimed at providing a more accommodative monetary environment. The MPC also reduced the Statutory Reserve Requirement (SRR) from 4% to 3.5% to further reduce the cost of intermediation, with effect from 1 December 2008. The committee also approved the schedule of MPC meetings for 2009.

30 October 2008

As part of greater engagement with its stakeholders, the Bank met with leaders of banking institutions and the Association of Banks Malaysia (ABM) to discuss issues on current economic developments and business conditions. The central bank emphasised the importance for banks to continue to engage in responsible lending behaviour, which may involve rescheduling and restructuring of facilities, as continuous access to financing is vital to sustain the country's economy. The banking industry agreed to heighten