

## ECONOMIC AND FINANCIAL DEVELOPMENTS IN MALAYSIA IN THE SECOND QUARTER OF 2007

### OVERVIEW

#### *Economy on a steady growth path*

The Malaysian economy continued to be on a steady growth path, with real GDP expanding by 5.7% in the second quarter of 2007 (1Q: 5.5%). Private sector activity remained resilient in the second quarter. The increased public sector spending provided added support to the growth. Sustained strong performance in the services sector and higher activities in the mining and construction sectors supported the growth in the second quarter.

The construction sector expanded further during the quarter (4.8%; 1Q: 4%), underpinned by the commencement of new projects under the Ninth Malaysia Plan and further supported by activities in the non-residential sector. In the mining sector, growth of 7.7% (1Q: -0.6%) was supported by higher output of both crude oil and natural gas. Output of natural gas increased strongly during the quarter, supported by rising demand from domestic electricity producers as well as external demand for liquefied natural gas, particularly from Japan and Korea.



The services sector, which grew by 9.2% in the second quarter (1Q: 9.7%), continued to benefit from increased finance and business activity as well as favourable stock market performance and increased demand for computer and professional services. Meanwhile, the wholesale and retail trade, accommodation and restaurant sub-sector recorded a higher growth during the quarter due to strong spending by domestic consumers as well as robust tourism activities. Growth in the transport, storage and communication sub-sector was also higher during the quarter led by strong growth in both the transportation and telecommunications

Although output of export-oriented industries declined during the quarter, weighed down mainly by the weakness in the electronics and electrical industry, the manufacturing sector continued to record a positive growth of 1.5% in the second quarter (1Q: 2%). Growth reflected the increase in production by domestic-oriented industries mainly led by strong demand for construction-related materials following the improvement in domestic construction activities. Meanwhile, the agriculture sector contracted by 0.9% in the second quarter (1Q: 2.2%), following the lower production of crude palm oil due to lower yields, as harvest activity was affected by unfavourable weather conditions.

Domestic demand expanded strongly in the second quarter (10.8%; 1Q: 8.7%), supported by private sector activity and continued increase in public investment spending. Private consumption expenditure was stronger, (13.1%; 1Q: 8.6%), supported by the steady increase in disposable income and stable employment market conditions as well as stronger commodity prices. In

addition, the favourable performance of the stock market reinforced consumer sentiments during the quarter. Meanwhile, gross fixed capital formation expanded by 6.6% in the second quarter (1Q: 9.9%), on continued capital spending activities by both the private and public sectors. The government development spending initiatives during the quarter were focussed on high-multiplier impact projects, mainly for agriculture and rural development, upgrading and construction of transportation related infrastructure and public utilities. Private sector capital spending activities expanded steadily, particularly in the manufacturing, construction and upstream oil and gas sectors, supported by improved business conditions.

The headline inflation rate, as measured by the change in the Consumer Price Index (CPI), moderated further to average 1.5% in the second quarter of 2007 (1Q: 2.6%), which is the lowest rate observed since the third quarter of 2004.

On the external front, the trade account recorded a higher surplus of RM22.5 billion (1Q: RM21.1 billion). While gross exports rose by 1.2% in the second quarter (1Q: 1%), reflecting higher exports of primary commodities amidst the strong prices, gross imports moderated to 1.7% (1Q: 5.5%). Agriculture exports, in particular, performed exceptionally well during the quarter, driven by the strong growth in palm oil exports following the double-digit increases in export prices. The factors that contributed to the surge in palm oil prices include the continued high global demand for palm oil, amidst the declining domestic production and stocks during the quarter, the rise in soybean oil prices as well as the decision by India to reduce its tariff on palm oil imports to be nearly on par with the tariff on soybean imports. Mineral exports also rose during the quarter, driven entirely by the rise in LNG exports, due to higher offtake by the major buyers as well as higher prices. Growth of manufacturing exports was subdued during the second quarter as a result of lower

electronics and electrical (E&E) exports. Exports of resource-based products however, remained strong, mainly supported by chemicals, petroleum and food products as well as furniture and parts.

The moderation in gross imports was attributable mainly to lower growth in intermediate imports (6.3%; 1Q: 9%). This reflected mainly the slower growth in imported inputs for manufactured exports, in tandem with the lower external demand for E&E products. Following continued growth in private consumption expenditure, import of consumption goods increased by 1.3% (1Q: 8.9%). Imports of capital goods amounted to RM16.6 billion in the second quarter. Excluding one-off large items, imports of capital goods expanded by 3.8% (1Q: -1.3%). This reflected higher imports of construction and mining equipments for continued exploration and downstream activities in the oil and gas sector, as well as imports of machinery and equipments for increased development activity and capacity expansion in the services and agriculture sectors.

In the financial account, net inflow of foreign direct investment (as captured by Bank Negara Malaysia's Cash BOP System which does not include retained earnings and investment in the form of imported machinery and equipment) increased to RM13.6 billion in the second quarter (1Q: RM0.8 billion). This reflected the larger inflows of equity into the services, agriculture and manufacturing sectors. Portfolio investment recorded a net inflow of RM14.5 billion in the second quarter (1Q: RM27.4 billion), while overseas investment recorded a larger net outflow of RM7.8 billion (1Q: -RM3.8 billion).

The international reserves of Bank Negara Malaysia amounted to RM339.8 billion or equivalent to USD98.4 billion as at end-June 2007. As at 15 August 2007, the reserves amounted to RM339.7 billion or equivalent to USD98.4 billion, sufficient to finance 8.9 months of retained imports and is 8.7 times the short-term external debt.

### ***Monetary policy remained supportive of economic activity***

The overnight policy rate (OPR) was unchanged at 3.50% throughout the second quarter of 2007 as the prevailing level of the policy rate remains consistent with the medium term outlook of low inflation and sustained economic growth.

Reflecting the unchanged OPR, interbank rates of all maturities remained stable during the quarter. Retail lending and deposit rates also remained relatively unchanged.

Financing to the private sector was higher in the second quarter, with banking system loans and private debt securities (PDS) outstanding expanding at a combined annual rate of 6.8% at the end of the second quarter. Banking system loans outstanding increased at an annual rate of 6%, with loans outstanding to businesses and households expanding by 6% and 7.2% respectively. The major loan indicators were higher on an annual basis. Loan applications and approvals were notably higher, driven mainly by the business sector.

M3, or broad money, increased at an annual rate of 12.6% as at end-June (1Q: 14.2%). There was a strong increase in net foreign assets during the second quarter following higher inflows in the form of export proceeds, net foreign investments and portfolio investments. Bank Negara Malaysia, through its sterilisation operations, limited the impact of the inflows on broad money expansion, maintaining a steady pace of M3 growth.

Net funds raised in the capital market by the public and private sectors were significantly higher, amounting to RM22 billion in the second quarter. The bulk of the funds were raised by the private sector in the private debt securities market for merger and acquisition activity, new activity and refinancing. On a net basis, the funds raised through the PDS market, excluding Cagamas,

amounted to RM12.4 billion. Meanwhile, funds raised in the equity market were slightly lower at RM512 million during the second quarter.

Amidst two-way trade and investment flows, the ringgit continued to strengthen against the US dollar going into the second quarter of 2007, appreciating by about 2% until end-May. The turbulence in global financial markets triggered by developments in the subprime market in the United States in July however culminated in the weakening of regional currencies, including the ringgit against the US dollar. Thus, following an extended period of appreciation since the beginning of the year, the ringgit depreciated with other regional currencies against the US dollar. Nevertheless, for the second quarter as a whole, the ringgit was relatively unchanged against the US dollar.

For the period 1 July – 28 August, the ringgit depreciated against the major and regional currencies in the range of 0.2% - 7.5%, the exception being an appreciation against the Indonesian rupiah (2.7%) and Korean won (0.4%).

### ***Continued high resilience in the banking sector***

The banking system continued to exhibit high resilience in the second quarter of 2007, supported by strong capitalisation and improved profitability. The risk-weighted capital ratio (RWCR) remained strong at 13.1%, while the pre-tax profit of the banking sector registered a strong growth of 17.6% to RM4.5 billion (1Q: RM3.8 billion) due mainly to higher income derived from both interest related activities and fee-based activities. The level of non-performing loans (NPLs) continued to improve with the total net NPLs based on the 3-month classification declining further to RM24.1 billion as at end of the second quarter (1Q: RM25.6 billion). Given the continuous improvement in loan quality, the net NPL ratio declined further to 4.1% of net total loans (1Q: 4.4%).

***Growth is expected to improve in the second half-year***

Going forward, the global economic expansion is expected to be sustained at above 4% in 2007. Despite the moderation in the US economy and ongoing uncertainties such as high oil prices and unstable conditions in the financial markets, favourable growth momentum in the European and Asian regions would sustain global growth over the near term. The recent turmoil in the US subprime mortgage and credit markets have so far been confined to the financial markets. While the financial markets can be expected to experience continued volatility, the strong fundamentals prevailing in Malaysia would continue to support the steady growth momentum of the Malaysian economy.

Forward looking indicators for Malaysia continued to point towards improved growth performance in the second half-year. The six-month smoothed growth of the index for leading indicators accelerated from

6.7% in April to 9.2% in May 2007. Factors that continue to support domestic demand include strong private consumption and investment spending as well as the pick up in Government development spending following implementation of projects under the Ninth Malaysia Plan. The MIER Consumer Sentiments Index for the second quarter has remained above the 100-point threshold for the fifth consecutive quarter. Private consumption is expected to be supported by positive labour market conditions, the continued growth in disposable incomes as well as firm commodity prices. Meanwhile, private investment is expected to expand at a steady pace. The MIER Business Conditions Index also rose significantly to 122.1 points in the second quarter (1Q: 105.5 points), indicating improved business sentiment. On the sectoral performance, growth is expected to be supported by further expansion in the services, mining as well as construction sectors, while the manufacturing sector is expected to benefit from the gradual recovery in the electronics industry.

## DEVELOPMENTS IN THE SECOND QUARTER OF 2007

### INTERNATIONAL ECONOMIC ENVIRONMENT

#### *Sustained growth in most major regions*

Global economic growth strengthened in the second quarter of 2007. Growth momentum was sustained in most major economies including the United States, euro area, Japan and People's Republic of China (PR China).

In the **US**, consumption growth moderated to 1.3% (1Q: 3.7 %) amid slowing housing market and higher gasoline prices. Nevertheless, the US economy expanded by 3.4% in the second quarter of 2007 (1Q: 0.6%), driven by strong non-residential property investment, higher government spending and better trade performance. The trade deficit narrowed, driven by broad-based growth in exports, including industrial supplies, consumer goods and capital goods. Imports contracted for the first time since the first quarter of 2003. The more recent turmoil in the subprime mortgage and credit markets has however resulted in some uncertainty on the impact it might have on consumption and the overall growth prospects.

In **Japan**, the economy grew at a moderate pace of 0.5% in the second quarter (1Q: 3.2%). The moderation was due mainly to the slowdown in the private consumption activity, after a robust performance in the first quarter. In addition, the slower growth also reflected lower exports particularly to the US. Nevertheless, in the latest Tankan survey released in July, Japanese businesses remain optimistic with plans to increase capital spending. The economy of the **euro area** expanded by 2.5% in the second quarter, supported by spending on capital equipment and robust net trade in Germany. In addition, continued improvement in the labour market and high levels of confidence

among consumers suggest continued income formation and rising consumer demand. In the **UK**, growth was sustained at 3% in second quarter, supported mainly by consumer spending and the services sector. Meanwhile, the manufacturing sector continued to register positive growth.

Industrial countries: Real GDP Growth						
	2006		2007		Key contributing factors for 2Q growth	
	2Q	1H	1Q	2Q		1H
Annual change (%)						
US <sup>1</sup>	2.4	3.3	0.6	3.4 <sup>a</sup>	1.7	Growth rebounded on higher fixed investment, government spending, exports and inventories.
UK	2.7	2.4	2.9 <sup>r</sup>	3.0 <sup>a</sup>	3.0	Supported mainly by the services sector and a rebound in the manufacturing sector.
Euro zone	2.9	2.8	3.1	2.5	2.8	Supported by trade and strong spending on capital equipment in Germany.
Japan <sup>1</sup>	1.7	2.4	3.2 <sup>r</sup>	0.5 <sup>a</sup>	2.5	Moderate growth due to the slowdown in private consumption and export activity.

<sup>1</sup> Annualised basis  
<sup>a</sup> Advance estimates  
<sup>r</sup> Revised

Source: National authorities

In the **US**, the **Federal Open Market Committee (FOMC)** maintained interest rates at 5.25% at its meeting on 28 June and 7 August 2007. Inflation remains a concern given the high level of resource utilisation. On 17 August however, the discount rate was reduced by 50 basis points to 5.75%. The **European Central Bank (ECB)** kept its interest rate unchanged at 4% for a second consecutive month at its policy meeting in August. Current rapid growth in money supply and lending has remained the main concern for the ECB. The **Bank of England** also kept its policy rate steady at 5.75%, although inflation had remained above target level of 2%. Similarly, the **Bank of Japan** maintained interest rates at 0.5% on 23 August.

Global **crude oil** prices edged up towards the end of second quarter, closing at USD70.69 per barrel on 29 June amid concerns over supplies in Nigeria and lower

US inventories level. Oil prices recorded a new high at USD78.77 per barrel on 1 August spurred by speculative purchase following strong economic data.

In the **Asian** region, economic activity remained strong despite the adjustment in the electronics and electrical (E&E) sector. Growth was supported by sustained domestic demand and non-E&E exports. The current moderation in regional E&E exports is projected to bottom out during the second half of the year as inventory continues to adjust and the growth in unit shipments of semiconductors mitigates the effects of lower average selling prices (ASPs).

Inflationary trends were mixed. The ASEAN-4<sup>1</sup> economies recorded lower inflationary pressures, while inflation rates were higher in PR China, Korea and Singapore due to a combination of higher food and asset prices. In terms of monetary policy, Indonesia, Thailand and the Philippines reduced interest rates in view of lower inflationary pressures and to spur domestic demand, while PR China, Korea and Chinese Taipei raised interest rates.

In the **foreign exchange market**, the US dollar ended the quarter weaker against major currencies. Interest rate differentials remained the major factor influencing the US dollar performance. In July, the pound reached a 26-year high against the US dollar, while the euro traded near record high against the dollar. This development was driven by expectations for a rate cut by the Federal Open Market Committee and prospects of further rate increases in Europe. Meanwhile, most regional currencies ended the quarter stronger compared with the first quarter, due to continued strong trade, and portfolio equity inflows. Subsequently, there was contagion from the volatile global capital markets in the foreign exchange markets in August.

#### Regional Countries: Real GDP Growth

	2006		2007			Key contributing factors for 2Q growth
	2Q	1H	1Q	2Q	1H	
	Annual change (%)					
PR China	11.5	11.0	11.1	11.9	11.5	Driven by exports and investment.
Singapore	8.0	9.1	6.4	8.6	7.5	Supported by the financial services and construction sectors.
Hong Kong SAR	5.5	6.8	5.7	6.9	6.3	Driven by investment, exports and private consumption.
Indonesia	5.1	5.0	6.0	6.3	6.1	Supported by investment and exports.
Chinese Taipei	4.6	4.7	4.2	5.1	4.6	Supported by strong private investment.
Korea	5.1	5.7	4.0	4.9 <sup>a</sup>	4.5 <sup>a</sup>	Supported by manufacturing and investment.

<sup>a</sup> Advanced estimates

Source: National authorities

<sup>1</sup>ASEAN-4 refers to Indonesia, Malaysia, the Philippines and Thailand

## DEVELOPMENTS IN THE MALAYSIAN ECONOMY

**The Malaysian economy continued on a steady growth path supported by sustained strong growth in the services sector, and higher growth in the mining and construction sectors**

The Malaysian economy continued on a steady growth path, with real GDP expanding by 5.7% in the second quarter of 2007, led mainly by strong performance in the services sector and further supported by higher growth in the mining and construction sectors. The services sector continued to benefit from strong spending by domestic consumers and tourists as well as increased finance and business activity amidst the development of new products and services, the entry of new players as well as favourable stock market performance. Growth in the construction sector picked up further supported by commencement of the Ninth Malaysia Plan projects and activity in the non-residential segment, while the mining sector was supported by higher output of both crude oil and natural gas. For the second consecutive quarter, the manufacturing

### Strong services activity...

The **services sector** expanded at a significantly higher growth (9.2%), led mainly by intermediate services.

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

	Share 2006	2006		2007		
		2Q	1H	1Q	2Q	1H
	%	Annual change in (%)				
<b>Intermediate Services</b>	<b>42.8</b>	<b>6.7</b>	<b>6.0</b>	<b>13.4</b>	<b>11.6</b>	<b>12.5</b>
Transport, storage & communication	14.2	6.2	5.4	5.4	8.6	7.0
<i>Transport &amp; Storage</i>	7.0	4.7	4.3	5.5	9.3	7.4
<i>Communication</i>	7.2	7.6	6.5	5.3	8.0	6.6
Finance, insurance, real estate & business services	28.6	7.0	6.3	17.6	13.1	15.3
<i>Finance &amp; Insurance</i>	19.8	6.8	6.5	13.2	11.0	12.1
<i>Real Estate &amp; Business Services</i>	8.8	7.5	6.0	27.3	18.0	22.6
<b>Final Services</b>	<b>57.2</b>	<b>7.2</b>	<b>7.4</b>	<b>6.8</b>	<b>7.4</b>	<b>7.1</b>
Electricity, gas & water	5.9	4.9	4.7	4.3	4.5	4.4
Wholesale & retail trade, accommodation & restaurant	26.6	6.9	7.6	8.9	11.6	10.3
<i>Wholesale &amp; retail trade</i>	22.3	7.3	8.2	9.1	11.9	10.5
<i>Accommodation &amp; Restaurant</i>	4.2	4.9	4.4	8.1	10.3	9.2
Government services	13.6	10.7	10.4	6.0	2.8	4.3
Other services	11.1	4.9	5.2	4.2	4.8	4.6
<b>Total Services</b>	<b>100.0</b>	<b>7.0</b>	<b>6.8</b>	<b>9.7</b>	<b>9.2</b>	<b>9.4</b>

Source: Department of Statistics, Malaysia

The **finance, insurance, real estate and business services** sub-sector continued to record a double-digit growth during the quarter mainly benefiting from the introduction of banking products and services and entry of the new players resulting in increased interest and fee-based income. Growth was also supported by business activities due to the favourable stock market performance, increased demand for professional services from the construction and oil and gas sectors as well as increased activity in IT services. Similarly, the **wholesale and retail trade, accommodation and restaurant** sub-sector recorded a strong growth underpinned by strong purchases by domestic consumers and robust tourism activities benefiting from the 2007 Visit Malaysia Year.

Growth in the **transport, storage and communication** sub-sector was higher during the quarter led by stronger growth in both

#### Quarterly GDP by Kind of Economic Activity at Year 2000 Prices

	2006		2007		
	2Q	1H	1Q	2Q	1H
	Annual Change in (%)				
Agriculture	3.9	4.9	2.2	-0.9	0.6
Mining	-1.1	-2.0	-0.6	7.7	3.5
Manufacturing	8.4	8.6	2.0	1.5	1.8
Construction	-0.5	-1.2	4.0	4.8	4.4
Services	7.0	6.8	9.7	9.2	9.4
<b>Real GDP (Ann. Chg.)</b>	<b>6.1</b>	<b>6.0</b>	<b>5.5</b>	<b>5.7</b>	<b>5.6</b>
<b>Real GDP (Preceding Chg.)</b>	<b>2.8</b>	<b>0.2</b>	<b>-1.7</b>	<b>2.9</b>	<b>0.0</b>

Source: Department of Statistics, Malaysia

sector expanded at a moderate pace, due to the weakness in external demand for the electronics and electrical (E&E) products. The performance in the agriculture sector was affected by lower oil palm yields due to weather-related factors.

the telecommunications and transportation segments. The telecommunication players generated higher revenue especially from the mobile segment due to strong demand for

voice and data services and larger customer base. Growth was also contributed by the increase in internet and broadband services following the active promotions by the players to increase their subscriber base. Increased air travel, sea transportation and port-related activities led to the higher growth in the transportation sub-sector.

### Selected Quarterly Indicators in the Services Sector

	2006		2007	
	2Q	1Q	2Q	1Q
	Percentage at end-period (%)			
Cellular phone penetration rate	80.8	77.0	78.0	
Internet subscribers penetration rate	14.0	14.0	14.2	
Broadband subscribers penetration rate	2.5	3.7	4.1	
	Index			
MIER Consumer Sentiment Index	104.2	124.1	115.9	
MIER Retail Trade Index	81.5	118.8	129.5	
MIER Tourism Market Index	110.0	133.8	131.6	
	Annual change (%)			
Total consumption credit outstanding	21.1	12.8	7.1	
Loans outstanding to the wholesale & retail trade, hotels & restaurants	15.5	10.1	0.0	
Imports of consumption goods	12.8	8.9	1.3	
Total sales of motor vehicles	-7.1	-15.5	-7.2	
Container cargo handled (Port Klang and PTP)	13.9	18.5	12.2	

Source: Various sources

### Expansion in the manufacturing sector led by domestic-oriented industries...

Value-added growth in the **manufacturing sector** registered a positive growth of 1.5% in the second quarter of 2007 (1Q: 2%) reflected the increase in production by domestic-oriented industries, while the export-oriented industries was affected by weakness in external demand for electronic products, particularly from the US market.

### Performance in the Manufacturing Sector

	2006		2007		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
<b>Value Added (at year 2000 prices)</b>	<b>8.4</b>	<b>8.6</b>	<b>2.0</b>	<b>1.5</b>	<b>1.8</b>
<b>Overall Production</b>	<b>8.7</b>	<b>8.8</b>	<b>0.7</b>	<b>0.4</b>	<b>0.5</b>
<b>Export-oriented industries</b>	<b>9.6</b>	<b>10.2</b>	<b>-0.2</b>	<b>-1.7</b>	<b>-1.0</b>
<i>Of which:</i>					
Electronics and electrical	8.3	12.6	-5.5	-6.2	-5.9
Electronics	12.4	17.5	-4.0	-4.5	-4.3
Electrical	-2.9	-0.3	-10.3	-11.3	-10.8
Chemicals and chemical products	10.8	8.3	7.3	1.4	4.3
Petroleum products <sup>1</sup>	15.5	11.9	5.0	11.3	8.1
Textiles, wearing apparel & footwear	14.5	12.6	-10.4	-10.6	-10.5
Wood and wood products <sup>2</sup>	-1.3	0.9	1.6	3.8	2.7
Rubber products	8.6	0.4	16.9	3.2	9.7
Off-estate processing	7.2	1.4	-1.3	-12.9	-7.7
<b>Domestic-oriented industries</b>	<b>5.3</b>	<b>3.3</b>	<b>4.8</b>	<b>9.0</b>	<b>7.0</b>
<i>Of which:</i>					
Non-metallic mineral products	1.2	-1.9	-2.0	11.3	5.0
Iron & steel and non-ferrous metal	-4.1	-6.9	12.9	18.6	15.9
Food	3.7	1.1	16.2	8.6	12.2
Transport equipment	3.9	5.3	-21.9	-14.9	-18.4
Fabricated metal products	24.4	20.0	21.9	24.4	23.3
<b>Total Manufactured Exports</b>	<b>10.0</b>	<b>10.3</b>	<b>1.4</b>	<b>-1.1</b>	<b>0.1</b>
<i>Of which:</i>					
Electronics and electrical products	5.6	6.9	-2.0	-6.7	-4.4
Chemicals and chemical products	9.9	1.3	33.8	13.3	22.9
Petroleum products	39.0	39.6	-24.5	5.0	-9.4
Wood and wood products	10.0	3.1	15.3	8.1	11.5
Furniture & parts	5.4	6.7	7.9	14.3	11.2
Rubber products	38.4	28.5	31.0	6.1	17.0

<sup>1</sup> 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

<sup>2</sup> Output of furniture and parts are not captured in the wood production data

Source: Department of Statistics, Malaysia

Output of **export-oriented industries** declined during the quarter (-1.7%; 1Q: -0.2%), mainly weighed down by the weakness in the electronics and electrical (E&E) industry (-6.2%; 1Q: -5.5%). The weakness was evident in the computer and parts segment arising from the subdued demand, particularly from the US. However, production of semiconductor components experienced a modest increase following an increase in demand from the non-US regions. Meanwhile, the chemical and chemical products industry recorded a moderate growth during the quarter due to normalization in output of plastic products after strong increases seen in the previous quarters. The industry was supported by growth in other segments, namely industrial gasses and construction-related plastic products.

### Capacity Utilisation in the Manufacturing Sector \*



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

Production of **domestic-oriented industries** was higher (9%; 1Q: 4.8%), supported by favourable domestic demand. Non-metallic mineral, and iron and steel products benefited from the improvement in domestic construction activities, expanding by 11.3% and 18.6% respectively (1Q: -2% and 12.9% respectively). In contrast, the transport equipment industry remained weak for the fourth successive quarter due to the spillover effects from the lackluster second hand car market and the demand for new vehicles.

### Performance in the Agriculture Sector

	2006		2007		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
<b>Value Added (at year 2000 prices)</b>	<b>3.9</b>	<b>4.9</b>	<b>2.2</b>	<b>-0.9</b>	<b>0.6</b>
Production <sup>1</sup>					
Of which:					
Crude palm oil	7.4	1.3	-1.4	-13.3	-8.0
Crude palm kernel oil	6.7	-0.9	3.3	-13.9	-6.2
Rubber	7.3	17.9	-6.9	1.2	-3.5
Cocoa	52.4	37.1	7.8	-10.5	-1.5
Fish	6.8	7.9	5.2	2.0	3.5
<b>Exports (RM million)</b>					
Of which:					
Palm oil ('000 tonnes)	-4.9	-1.4	-11.8	-5.7	-8.6
(RM/tonne)	1.0	-1.7	34.0	49.6	42.5
(RM million)	-4.0	-3.1	18.2	41.0	30.3
Palm kernel oil ('000 tonnes)	-23.3	-34.6	40.9	32.7	36.1
(RM/tonne)	-19.6	-16.4	-3.9	28.9	14.5
(RM million)	-38.3	-45.3	35.4	71.1	55.8
Rubber ('000 tonnes)	5.1	4.0	-12.3	-19.6	-16.0
(Sen/kilogramme)	53.9	49.0	-0.7	2.0	0.4
(RM million)	61.7	55.0	-12.9	-18.0	-15.6
Sawn timber ('000 cu.metres)	-15.1	-17.4	-2.1	-11.3	-6.7
(RM/cu.metre)	17.6	26.8	9.7	2.7	6.3
(RM million)	-0.1	4.8	7.4	-8.9	-0.9
Saw logs ('000 cu.metres)	-23.0	-21.2	-8.3	0.8	-3.7
(RM/cu.metre)	9.9	13.8	-2.5	-4.2	-3.4
(RM million)	-15.4	-10.4	-10.5	-3.4	-7.0
Cocoa beans ('000 tonnes)	1.6	48.4	-13.5	42.1	6.7
(RM/tonne)	1.4	0.1	4.8	10.5	8.1
(RM million)	3.1	48.6	-9.3	57.0	15.4

<sup>1</sup> In '000 tonnes, except for saw logs in '000 cubic metres

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

Overall, the manufacturing sector was operating at the capacity utilisation rate of 75% in the second quarter of 2007 (1Q: 75%), with both export- and domestic-oriented industries averaging 76% and 71% respectively (1Q: 77% and 67% respectively).

### Primary commodities supported by strong growth in mining sector

Performance in the **primary commodity sector** was supported by strong growth in the mining sector (7.7%), due to both higher output of crude oil and natural gas. Meanwhile, the agriculture sector recorded a subdued performance (-0.9%) due to lower output of crude palm oil during the quarter.

In the **agriculture sector**, production of **crude palm oil** declined by 13.3% to 3.49 million tonnes (1Q: -1.4%) due to lower yields. Fresh fruit bunches (FFB) averaged 4.17 tonnes per hectare during the quarter compared with 4.95 tonnes per hectare in the second quarter of 2006 as harvest activity, particularly in the key producing states was affected by unfavourable weather conditions. Following the seasonal wintering which ended in early May, output of **rubber** turned around to increase by 1.2% in the second quarter of 2007 (1Q: -6.9%). The high prices (2Q 2007: 741 sen per kilogramme) supported tapping

activity, especially among the smallholders. Meanwhile, the food crop segment continued to lend support to the agriculture sector during the quarter. Growth emanated from higher production of livestock, vegetables and fish, due mainly to increases in marine fish landings led by the substantial rise in deep sea tuna fish.

In the **mining sector**, production of **crude oil** (including condensates) strengthened by 7.6% to 676,282 barrels per day during the quarter (2Q 2006: 628,341 barrels per day). The development was further augmented by stronger output of **natural gas**, which rose by 8% to 5,928 million standard cubic feet per day, supported by rising demand from the domestic electricity producers as well as external demand for liquefied natural gas, particularly from Japan and Korea.

### Construction sector continued to expand ...

The construction sector continued on its growth momentum (4.8%;1Q: 4%), mainly supported by the **civil engineering** and non-residential sub-sectors. The former was underpinned by implementation of infrastructure projects related to the Ninth Malaysia Plan as well as oil and gas projects, while the latter was supported by new buildings of office and retail space, especially in the Klang Valley. Activity in the **residential** segment also picked up during the quarter supported by demand for high-end property in selected locations.

### Strong expansion in domestic demand

**Domestic demand** registered a strong increase of 10.8% in the second quarter

### Performance in the Mining Sector

	2006		2007		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
<b>Value Added (at year 2000 prices)</b>	-1.1	-2.0	-0.6	7.7	3.5
<b>Production</b>					
<i>Of which:</i>					
Crude oil and condensates ('000 barrels)	-4.2	-3.3	-1.9	7.6	2.7
Natural gas (net) (million standard cubic feet)	-3.0	-4.5	1.1	8.0	4.4
<b>Exports (RM million)</b>					
<i>Of which:</i>					
Crude oil and condensates ('000 tonnes)	-5.3	-6.3	3.2	-3.8	-0.2
(USD/barrel)	31.0	35.8	-5.6	3.2	-1.4
(RM million)	19.2	23.4	-8.6	-6.6	-7.6
Liquefied natural gas ('000 tonnes)	-8.5	-5.3	4.5	21.0	11.7
(RM/tonnes)	15.2	17.6	-0.2	6.4	2.9
(RM million)	5.4	11.4	4.3	28.8	14.9

Source: PETRONAS  
Department of Statistics, Malaysia

### Construction Indicators

	2006		2007		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
New sales and advertising permits	-20.3	-21.9	7.7	-6.3	0.4
Housing approvals	-7.4	-29.0	-9.6	-24.8	-17.5
Production of construction-related materials	-0.6	-3.6	2.8	13.7	8.5
Loans approved for construction	5.7	-12.5	81.8	103.8	94.9
Imports of construction materials and mineral products	-0.8	0.9	12.6	10.7 <sup>1</sup>	11.8 <sup>2</sup>

<sup>1</sup> April-May 2007  
<sup>2</sup> January-May 2007

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

(1Q: 8.7%), driven by private sector activity. The public sector sustained its supportive role as the Federal Government stepped up its development expenditure. As in the previous quarters, consumption expenditure, especially from the household sector, remained as the main contributor to domestic demand growth during the quarter.

**Private consumption** expenditure was stronger, increasing by 13.1%, supported by the steady increase in disposable income and stable labour market conditions as well as stronger commodity prices. At the same time, the favourable performance of the stock market reinforced consumer sentiment during the quarter. The latest Consumer Sentiment Index (CSI) compiled by the Malaysian

Institute of Economic Research (MIER), remained above 100-points for the fifth consecutive quarter. Major consumption indicators, such as imports of consumption goods, consumer spending on credit cards and loans disbursed for consumption purposes, remained on a positive growth trend reflecting prospects for continued expansion in consumer spending activity.

Meanwhile, **public consumption** was higher, recording a growth rate of 10.2% in the second quarter due to higher expenditure for emoluments and supplies and services.

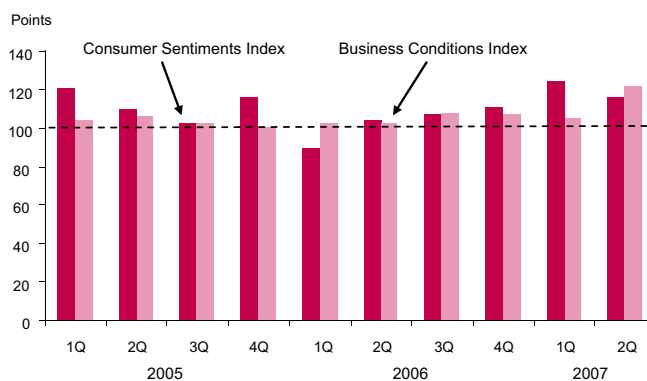
**Gross fixed capital formation** increased by 6.6% in the second quarter, as capital spending activities by both the private and public sector gathered momentum. Public sector capital spending continued to increase at a firm rate as evidenced by the higher disbursements of development expenditure by the Federal Government. During the quarter, government development spending initiatives were focussed on high-multiplier impact projects, mainly for agriculture and rural development, upgrading and construction of transportation related infrastructure and public utilities as well as improving the provisions of education services. Meanwhile, the steady expansion in private sector capital spending activities was notable in the manufacturing, construction and upstream oil and gas sectors. The MIER's second quarter Business Conditions Index rose significantly by 16.6 points from the previous quarter (122.1 points; 1Q: 105.5 points), signifying improved business sentiment. Indicators such as approved business loans and sales of construction-related materials recorded strong double-digit growth, pointing to expansion in investment activities in the manufacturing and construction sectors.

### GDP by Expenditure Components (at constant 2000 prices)

	2006		2007		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
Aggregate Domestic Demand (excluding stocks)	7.2	7.2	8.7	10.8	9.8
Consumption	7.1	6.4	8.3	12.6	10.4
Private sector	7.7	7.2	8.6	13.1	10.8
Public sector	4.5	2.9	7.1	10.2	8.8
Gross Fixed Capital Formation	7.6	9.4	9.9	6.6	8.1
Exports of Goods and Services	5.5	6.2	1.9	3.0	2.5
Imports of Goods and Services	9.2	10.5	3.5	1.4	2.4
<b>GDP</b>	<b>6.1</b>	<b>6.0</b>	<b>5.5</b>	<b>5.7</b>	<b>5.6</b>

Source: Department of Statistics, Malaysia

### Business Confidence Improved, while Consumer Sentiment was Sustained



Source: Malaysian Institute of Economic Research (MIER)

### Inflation continued to moderate in the second quarter

The headline inflation rate, as measured by the change in the Consumer Price Index (CPI), moderated further to average 1.5% in the second quarter of 2007 (1Q: 2.6%), which is the lowest rate observed since the third quarter of 2004.

Several categories of goods and services experienced either slower price increases or declining prices during the quarter. The annual growth rate of transport prices decelerated to 1.1% in the second quarter from 6.1% in the first quarter of 2007, as there was no new impetus to prices in this sector after the lapse of the impact of the upward adjustments in retail petroleum product

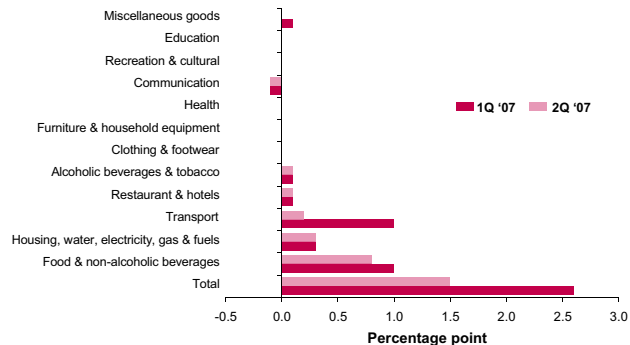
prices in March 2006. Prices for the food and non-alcoholic beverages category increased at a more moderate pace of 2.6% in the second quarter (1Q: 3.1%). The inflation rates of restaurants and hotels and recreation and culture however, were higher in the second quarter, due mainly to the price adjustments that took place in selected consumption goods and services. These price increases were partially offset by the continued decline in prices for the clothing and footwear and communication categories. Lower inflation is supported by expanding production capacity and competitive pressures in various goods and services markets.

Producer price inflation moderated to 3.9% in the second quarter (1Q: 4.3%), as prices in the non commodity-related category rose at a slower pace of 2.6% (1Q: 4.9%). Inflation in the commodity-related category, in contrast, increased sharply by 8.3% (1Q: 2.9%), reflecting price increases for crude oil, crude palm oil and natural rubber during the quarter.

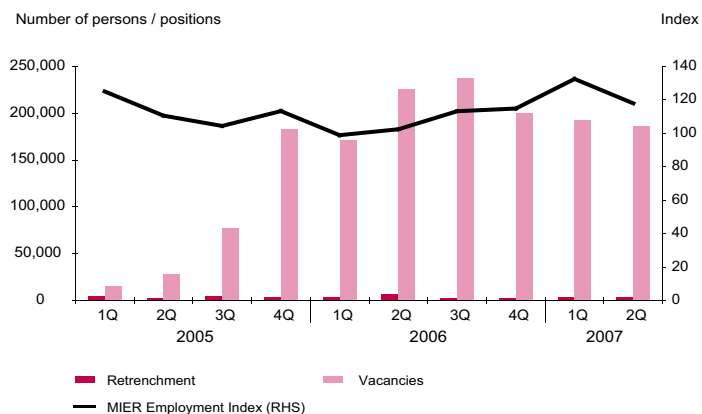
### Labour market still resilient

**Labour market** conditions remained stable in the second quarter of 2007 with high level of job vacancies in all economic sectors. Total new vacancies in the second quarter reported via the Electronic Labour Exchange (ELX) remained high at 186,779 positions (1Q: 193,188 positions), with significant job openings in the manufacturing (32% share), services (26%) and agriculture (26%) sectors. Although most of the positions available in the ELX were mainly for lower skilled jobs such as elementary occupations (52%), total new vacancies at the graduate level posted a significant yearly increase of 78%. A large number of job openings for graduates was

### Contribution to Consumer Price Inflation



### Labour Market Conditions



in the services sector (54% share of total vacancies for graduates), especially in the financial and education industries. Similarly, job offers for professionals, associate professionals and technicians doubled compared with the corresponding period last year. In addition, total job placements stayed high in the second quarter.

There was a slight increase in the total number of retrenchments in the second quarter (4,202; 1Q: 4,180) affecting mainly workers in the manufacturing sector (70% share), especially in the E&E industry (40% of total retrenchments), which was hit by lower demand, high production cost and financial difficulties. The retrenchments mainly involved plant and machine operators, assemblers and general workers as well as craft and related trade workers (63%).

Labour productivity, as indicated by real sales value per employee in the manufacturing sector, fell by 1.4% in the second quarter (1Q: -3.2%), due mainly to the weak sales performance (2.3%) relative to higher employment growth (3.2%). For the second consecutive quarter, the sector's productivity performance was dragged down by the decline in labour productivity growth in the export-oriented industries (-2.8%; 1Q: -4.7%), on account of poor sales performance (0.9%). Meanwhile, real wages increased marginally by 1.4%, indicating the presence of slight wage pressures in the sector.

### Moderate expansion in both exports and imports

The **trade account** recorded a surplus of RM22.5 billion in the second quarter of 2007 (1Q: RM21.1 billion). Export growth of 1.2% reflected higher agriculture and mineral exports, while the moderation in import growth to 1.7% was attributable mainly to lower growth in intermediate imports.

**Gross exports** rose by 1.2% in the second quarter of 2007 (1Q: 1%) mainly led by higher exports of primary commodities amidst the strong prices.

During the quarter, **agriculture exports** performed exceptionally well, driven mainly by the significant rise in palm oil exports. The

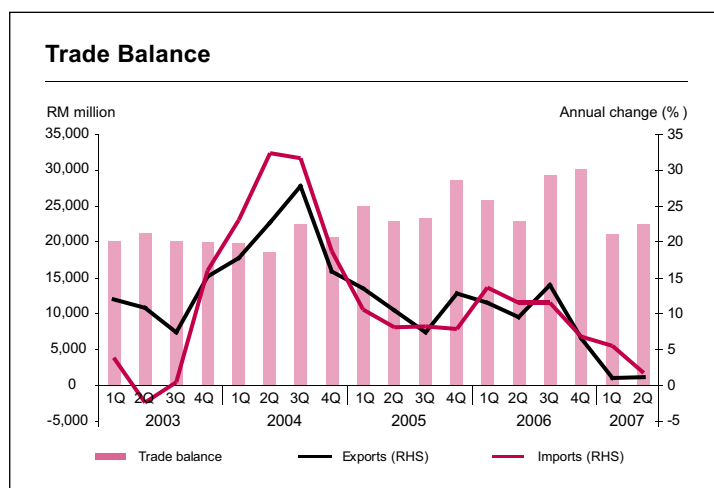
### Trade Account

	2006		2007		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
<b>Gross Exports</b>	<b>9.5</b>	<b>10.5</b>	<b>1.0</b>	<b>1.2</b>	<b>1.1</b>
Manufacturing	10.0	10.3	1.4	-1.1	0.1
Agriculture	3.3	3.9	25.0	19.0	21.9
Minerals	10.1	16.6	-7.4	8.4	0.1
<b>Gross Imports</b>	<b>11.5</b>	<b>12.6</b>	<b>5.5</b>	<b>1.7</b>	<b>3.5</b>
Capital goods	7.9	16.7	-5.3	-0.5	-2.8
Intermediate goods	7.8	8.0	9.0	6.3	7.6
Consumption goods	12.8	13.4	8.9	1.3	5.0
<b>Trade balance (RM billion)</b>	<b>22.9</b>	<b>48.6</b>	<b>21.1</b>	<b>22.5</b>	<b>43.6</b>

Source: Department of Statistics, Malaysia

strong growth was caused by the double-digit increase in export prices (49.6%) to RM2,185 per tonne induced by the continued high global demand for palm oil, especially from the People's Republic of China, European Union, India and the US, amidst the declining domestic production and stocks during the quarter. The development was further reinforced by the rise in soybean oil prices due to extensive switching of the crop to corn planting in the US to fulfill domestic demand for biofuel. The decision by India, the largest edible oil market in the world, to reduce its tariff on palm oil imports to be nearly on par with the tariff on soybean imports has also been a major contributing factor to the surge in palm oil prices. **Mineral** exports also rose during the quarter driven entirely by the rise in LNG exports due to higher offtake by the major buyers, namely Korea and Japan, as well as higher prices.

Growth in **manufacturing exports** was subdued as a result of lower electronics and electrical (E&E) exports. The decline in the export earnings of electronic products (-6.7%; 1Q: -2%) was attributed to lower demand for computers and parts, particularly from the US market and falling global prices of semiconductors. Exports of electrical products were also affected by transition by some manufacturers from lower-end products such as the cathode ray tube televisions and radios to higher value added



audio-visual products. In contrast, exports of resource-based products remained strong, mainly supported by chemicals, petroleum and food products as well as furniture and parts.

Malaysia's exports to the regional countries (excluding Japan) slowed down to 0.2% (1Q: 1.3%) in line with weak external demand for E&E products. The exports share, however, remained large at 44.3%. The export performance was driven mainly by PR China, Indonesia and Korea, underpinned by the demand for resource-based products such as petroleum-related products, chemical and rubber products. In the second quarter of 2007, exports to PR China, Indonesia and Korea expanded by 18%, 18.6% and 14.1%, respectively.

Exports to the EU, led by Germany, Netherlands and Belgium, expanded by 19.9%, 21.5% and 17.8%, respectively (1Q: 21.9%, 5% and 25.9%, respectively), comprising mainly E&E products, chemical products, palm oil, as well as iron and steel products. Export growth to India strengthened by 13.9% (1Q: 7.1%), underpinned mainly by strong demand for E&E products, iron and steel products and palm oil.

Malaysia continued to source import components from Singapore, PR China,

Thailand and Hong Kong SAR. Imports from regional countries increased by 3.1% in the second quarter of 2007, reflecting mainly imports of E&E products, chemicals and chemical products, manufactures of metal and iron and steel products.

**Gross imports** increased, though at a more moderate pace of 1.7% (1Q: 5.5%). Imports of **intermediate goods** expanded by 6.3% (1Q: 9%) to RM87.9 billion, reflecting mainly imports of processed food and beverages for industry, as well as primary and processed industrial supplies such as metals, wood pulp and chemicals. Following continued growth in private consumption expenditure, import of **consumption goods** increased by 1.3% (1Q: 8.9%) to RM6.9 billion, driven mainly by imports of consumer durables and non-durable goods, such as electrical goods, furniture as well as medicines. The steady increase in disposable income also led to growth in imports of food and beverages for household consumption (2.6%; 1Q: 15%).

Imports of **capital goods** amounted to RM16.6 billion. Imports of capital goods, excluding one off large items expanded by 3.8% (1Q: -1.3%). Growth in imports of construction and mining equipment strengthened, spurred by continued exploration and downstream activities in the

### Malaysia: Direction of Exports

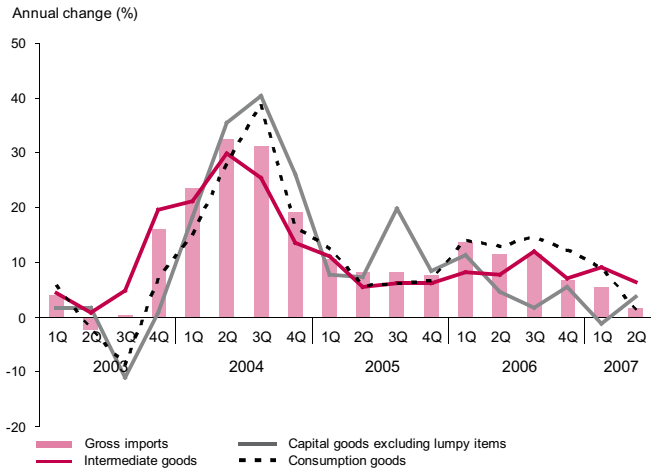
	2006		2007			2006		2007			2006		2007		
	2Q	1H	1Q	2Q	1H	2Q	1H	1Q	2Q	1H	2Q	1H	1Q	2Q	1H
	RM billion					Share of total exports (%)					Annual change (%)				
United States	28.1	52.6	23.7	22.8	46.6	19.6	18.8	17.2	15.8	16.5	4.3	8.3	-3.2	-18.7	-11.5
European Union (EU) <sup>1</sup>	17.6	33.7	17.7	19.4	37.1	12.3	12.1	12.8	13.4	13.1	17.5	14.1	9.7	9.6	9.6
Selected ASEAN countries <sup>2</sup>	37.8	75.2	35.6	36.0	71.6	26.4	26.9	25.8	24.9	25.3	12.0	13.3	-4.8	-4.8	-4.8
North East Asia	26.2	51.4	27.8	28.1	55.9	18.3	18.4	20.1	19.4	19.8	8.8	8.1	10.2	7.3	8.7
People's Republic of China	9.9	18.3	11.2	11.7	22.9	6.9	6.5	8.1	8.1	8.1	20.3	12.5	34.6	18.0	25.5
Hong Kong SAR	7.3	14.8	6.3	6.6	12.9	5.1	5.3	4.6	4.5	4.6	-7.7	-1.1	-15.6	-10.2	-13.0
Chinese Taipei	4.1	7.3	3.8	4.3	8.0	2.8	2.6	2.7	2.9	2.8	7.3	7.2	15.4	4.6	9.5
Korea	4.9	11.0	6.5	5.6	12.1	3.4	3.9	4.7	3.9	4.3	18.9	15.5	5.9	14.1	9.6
India	4.1	8.1	4.2	4.7	8.9	2.9	2.9	3.1	3.2	3.2	26.1	16.7	7.1	13.9	10.5
Total exports	143.2	279.9	138.1	144.9	283.0	100.0	100.0	100.0	100.0	100.0	9.5	10.5	1.0	1.2	1.1

<sup>1</sup> Refers to European Union (EU) 27 from 2007 onwards

<sup>2</sup> Singapore, Thailand, Indonesia, Philippines, Brunei Darussalam and Vietnam

Source: Department of Statistics, Malaysia

### Import Growth



### Significant FDI and portfolio investment inflows

On a cash basis, gross inflows of foreign direct investment (FDI) increased significantly to RM22.3 billion (1Q: RM7.3 billion) reflected the larger inflows of both the equity capital and inter-company loans from parent companies abroad. FDI in the form of equity capital were broad based, channeling mainly into services, agriculture and manufacturing sectors. In the services sector, FDI inflows were concentrated in the financing, insurance and business services sub-sectors. Inflows of FDI in agriculture sector were largely due to the acquisition of shares of a Malaysian palm oil company by a Singapore-based plantation company. In the manufacturing sector, FDI were largely into the food, petroleum-related, and chemical industries. Meanwhile, the bulk of the inter-company loans were in the form of short-term loans extended by foreign companies to their subsidiaries in Malaysia, particularly in the services sub-sectors and oil and gas sectors. The bulk of these loans were repaid during the same quarter. After adjusting for gross outflows due mainly to repayments of these short-term loans, net FDI increased significantly to RM13.6 billion (1Q: RM0.8 billion). The FDI on cash basis does not include retained earnings and investment in the form of imported machinery and equipment.

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

	2006		2007		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
<b>CAPITAL GOODS</b>	7.9	16.7	-5.3	-0.5	-2.8
Capital goods (except transport equipment)	2.3	8.6	-4.9	6.8	1.1
Transport equipment	50.5	92.2	-7.7	-38.6	-23.6
<b>INTERMEDIATE GOODS</b>	7.8	8.0	9.0	6.3	7.6
Food and beverages, mainly for industry	28.0	28.5	4.0	11.3	7.9
Industrial supplies, n.e.s.	0.9	1.0	24.1	22.2	23.1
Fuel and lubricants	40.1	30.7	8.8	-4.9	1.4
Parts and accessories of capital goods (except transport equipment)	7.2	8.2	2.8	-1.4	0.6
Parts and accessories of transport equipment	-8.3	-0.6	-18.3	8.7	-4.6
<b>CONSUMPTION GOODS</b>	12.8	13.4	8.9	1.3	5.0
Food and beverages, mainly for household consumption	5.4	4.4	15.0	2.6	8.7
Transport equipment, non-industrial	16.4	19.6	-12.1	2.8	-4.1
Consumer goods, n.e.s.	17.2	18.9	5.8	0.6	3.1
Durables	-7.5	10.3	0.3	34.5	15.9
Semi-durables	41.6	34.9	7.1	-20.2	-8.1
Non-durables	13.8	12.8	8.0	3.5	5.7
<b>DUAL USE GOODS</b>	1.0	10.9	-8.1	-6.2	-7.2
<b>OTHERS</b>	8.6	10.2	15.7	16.7	16.2
<b>RETAINED IMPORTS</b>	7.9	9.7	6.4	4.8	5.6
<b>RE-EXPORTS</b>	92.8	72.3	-6.9	-37.0	-23.4
<b>GROSS IMPORTS</b>	11.5	12.6	5.5	1.7	3.5

Source: Department of Statistics, Malaysia

oil and gas sector. Imports for machinery, generators, turbines and electric motors also expanded, attributable to increased development activity and upgrading for fuel efficiency. Meanwhile, favourable agriculture prices continued to promote capacity expansion in the sector, leading to high imports of agriculture equipment.

**Overseas investment** by Malaysian companies increased to RM26.9 billion (1Q: -RM24.8 billion), reflecting mainly large short-term loan extensions by non-resident controlled companies in the manufacturing sector to their related companies abroad,

arising partly from their centralised treasury operations. There were also significant outflows of equity capital due to acquisition of shares of a Singapore-based plantation company by Malaysian companies. These outflows were largely offset by inflows arising from repayment of short-term inter-company loans during the quarter. After adjusting mainly for these short-term loans, overseas investment recorded a larger net outflow of RM7.8 billion (1Q: -RM3.8 billion). The bulk of the overseas investment were by companies in the manufacturing, services and oil and gas sectors. In the manufacturing sector, overseas investment were channeled mainly into the plantation, E&E and petroleum-related industries. Meanwhile, overseas investments by the services sector were led by companies in the financing, insurance and business as well as telecommunication sub-sectors.

**Portfolio investment** recorded a net inflow of RM14.5 billion (1Q: RM27.4 billion,) reflecting mainly inflows in both equity and debt securities. The continued inflows of portfolio funds reflected positive investor sentiment due to stronger fundamentals and expectations of stronger corporate earnings.

### External debt within prudential level

External debt of Malaysia amounted to RM181.9 billion or USD52.2 billion as at end-June 2007 (1Q: RM178.9 billion or USD51.3 billion), equivalent to 32% of GNP. The **medium and long-term external debt** was lower at RM135 billion, reflecting net repayment of external loans by both the public and private sectors. The significantly higher net loan repayment by the NFPEs (-RM2.3 billion; 1Q: -RM0.2 billion) was attributed mainly to the maturity of a USD denominated bond issued by a company in the utilities sector and prepayment of external loan by a telecommunication company. Meanwhile, the Federal Government

recorded a smaller net repayment of RM0.1 billion (1Q: -RM0.4 billion). The private sector recorded a net repayment of RM1.4 billion (1Q: +RM0.03 billion) due mainly to the maturity of a USD denominated bond issued by a finance, insurance and business services company and several prepayments of loans by companies in the oil and gas, agriculture and transportation sectors to reduce their debt exposure.

The total **short-term external debt** increased to RM46.9 billion or USD13.4 billion (1Q: RM39.4 billion), reflecting higher short-term borrowings by the banking sector. As at end-June, the short-term external debt accounted for 25.8% of total external debt and is 13.8% of the net international reserves.

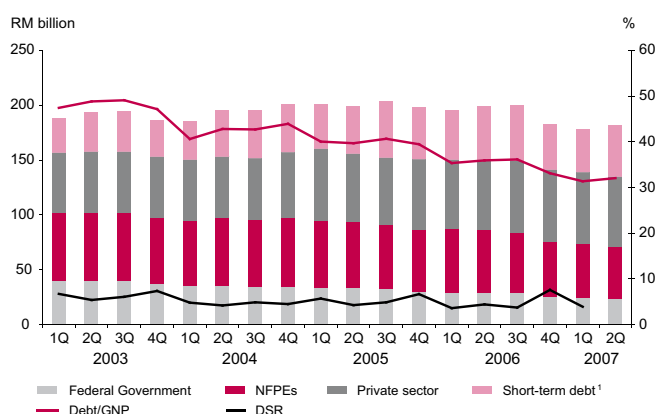
#### External Debt Outstanding

	2006		2007	
	2Q	1Q	1Q	2Q <sup>P</sup>
	RM billion			
Medium- and long-term debt	150.1	139.5	135.0	
Public sector	86.2	73.8	70.8	
Private sector	63.8	65.7	64.2	
Short-term debt <sup>1</sup>	48.7	39.4	46.9	
Total external debt	198.7	178.9	181.9	
- USD billion equivalent	53.6	51.3	52.2	

<sup>1</sup> Excludes currency and deposits held by non-residents with resident banking institutions  
<sup>P</sup> Preliminary

Source: Ministry of Finance, Malaysia and Bank Negara Malaysia

#### External Debt Outstanding



<sup>1</sup> Excludes currency and deposits held by non-residents with resident banking institutions

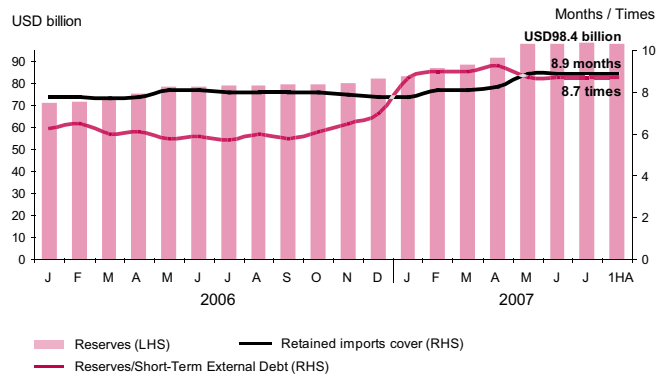
### International reserves

The international reserves of Bank Negara Malaysia amounted to RM339.8 billion or equivalent to USD98.4 billion as at end-June 2007. The reserves level has taken into account the quarterly revaluation gain, following the strengthening of the major currencies against ringgit during the quarter. The reserves amounted to RM339.7 billion or equivalent to USD98.4 billion as at 15 August 2007. The reserves position is sufficient to finance 8.9 months of retained imports and is 8.7 times the short-term external debt.

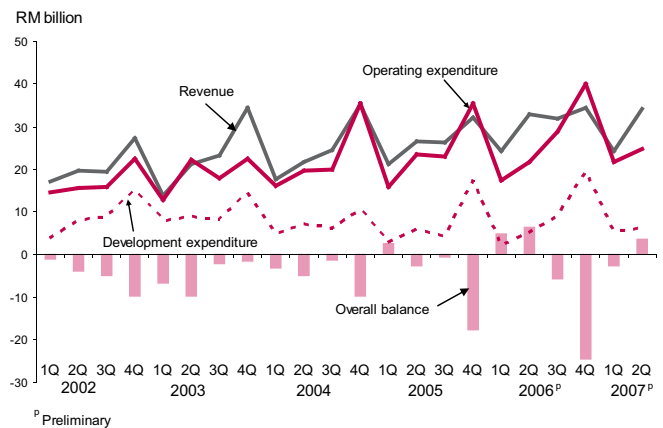
### Federal Government finance registered a surplus

Total gross expenditures in the second quarter of 2007 rose at an annual pace of 15.7% (1Q: 38.7%), attributed mainly to prompt Government disbursements and scheduled implementations of developmental projects. Revenue grew modestly in the second quarter, as the Government stepped up collection efforts. The Federal Government's financial position recorded an overall surplus of RM3.6 billion or 2.4% of GDP, compared to a fiscal surplus of 4.6% of GDP for the same period last year. During the quarter, funds were raised entirely from domestic sources. By end-June 2007, the Federal Government total outstanding debt stood at RM260 billion or 42.6% of the estimated GDP.

### Net International Reserves (as at end period)



### Federal Government Finance



### Federal Government Finance<sup>P</sup>

	2006		2007		
	2Q	1H	1Q	2Q	1H
	RM billion				
Revenue	33.0	57.3	24.2	34.2	58.4
% growth	24.2	19.9	0.1	3.5	2.0
Operating expenditure	21.6	38.9	21.7	24.8	46.5
% growth	-7.7	-1.0	25.2	14.7	19.4
<b>Current account</b>	<b>11.4</b>	<b>18.3</b>	<b>2.5</b>	<b>9.4</b>	<b>11.9</b>
% of GDP	<b>8.2</b>	<b>6.7</b>	<b>1.8</b>	<b>6.3</b>	<b>4.1</b>
Gross development expenditure	5.2	7.4	5.3	6.2	11.6
% growth	-12.2	-15.6	148.4	19.6	57.0
<b>Overall balance</b>	<b>6.4</b>	<b>11.3</b>	<b>-2.6</b>	<b>3.6</b>	<b>1.0</b>
% of GDP	<b>4.6</b>	<b>4.1</b>	<b>-1.8</b>	<b>2.4</b>	<b>0.3</b>
<b>Memo item:</b>					
Total gross expenditure	26.8	46.3	27.0	31.0	58.0
% growth	-8.6	-3.6	38.7	15.7	25.4
Total Federal Government debt (as at end-period)	240.2	240.2	250.0	260.1	260.1
% of GDP	42.0	42.0	40.9	42.6	42.6
Domestic debt	211.1	211.1	225.9	236.3	236.3
% of GDP	36.9	36.9	37.0	38.7	38.7
External debt	29.1	29.1	24.1	23.8	23.8
% of GDP	5.1	5.1	3.9	3.9	3.9

<sup>P</sup> Preliminary

## MONETARY AND FINANCIAL DEVELOPMENTS

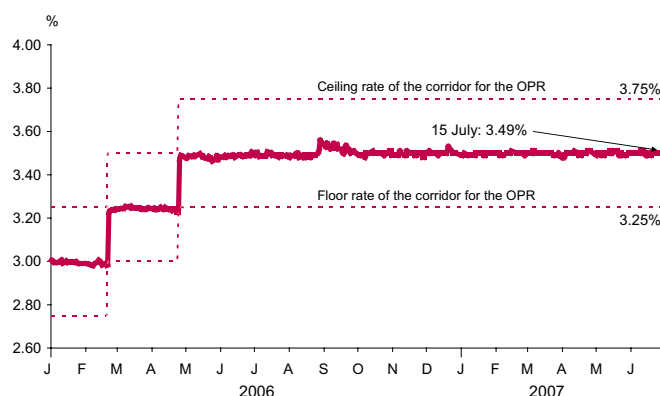
### *Lending rates remained relatively stable*

The Overnight Policy Rate (OPR) was unchanged at 3.50% throughout the second quarter of 2007 as the prevailing level of the policy rate remains consistent with the medium term outlook of low inflation and sustained economic growth.

Reflecting the unchanged OPR, the average overnight interbank rate was steady, moving within a tight range of 3.48% to 3.51% during the period 1 April – 15 July. Despite the expansion in liquidity driven by the external sector, interbank rates also remained relatively stable, as active sterilisation by Bank Negara Malaysia has kept liquidity growth in check.

In terms of lending rates, the average base lending rate (BLR) of commercial banks (CBs) was unchanged at 6.72%. The average lending rate (ALR), was marginally lower at 6.49% as at end-June, compared with 6.54% at end-March, as keen competition between banks put downward pressure on new loan rates. The average quoted fixed deposit (FD) rates of CBs for the 1-month and 12-month maturities, were relatively unchanged, ranging between 3.09% and 3.71% at the end of the second quarter (1Q: 3.10% to 3.71%).

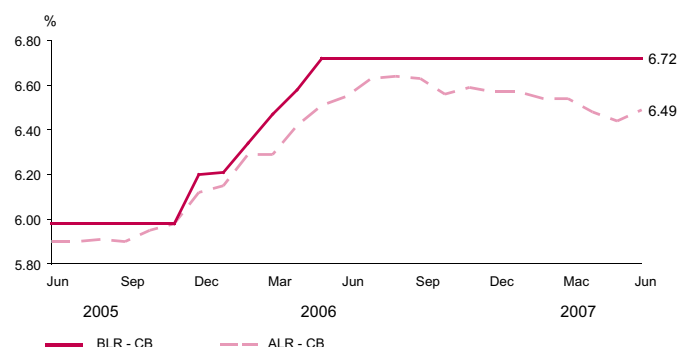
**Daily Weighted Average Overnight Interbank Rate**



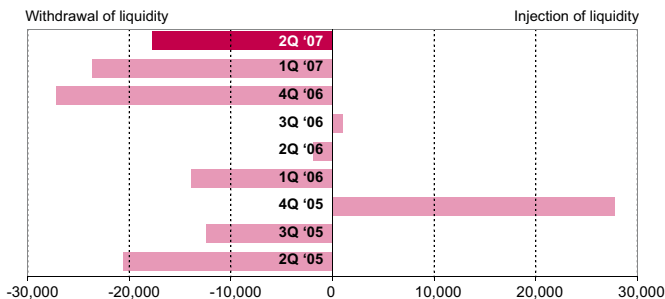
**Interest Rates**

	2006	2007	
	2Q	1Q	2Q
	At end-period (%)		
Overnight Policy Rate (OPR)	3.50	3.50	3.50
Interbank rates			
Overnight	3.51	3.50	3.50
1-month	3.78	3.55	3.54
Base lending rates (BLR)			
Commercial banks	6.72	6.72	6.72
Average lending rates (ALR)			
Commercial banks	6.55	6.54	6.49
Fixed deposit rates			
Commercial banks			
3-month	3.18	3.18	3.17
12-month	3.75	3.71	3.71

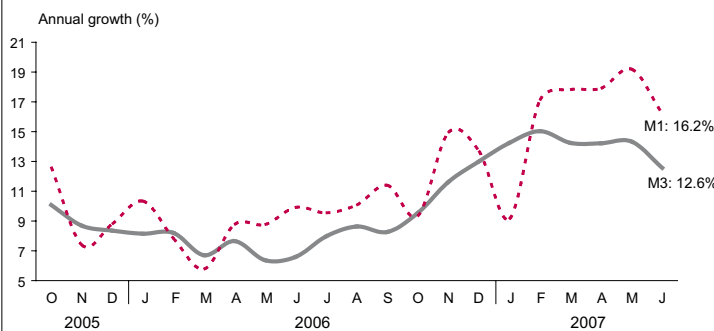
**Lending Rates of Commercial Banks**  
(Average for the period)



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



### Monetary Aggregates



### Determinants of Broad Money, M3

	Change during the period				
	2006			2007	
	2Q	3Q	4Q	1Q	2Q
<b>M3</b>	<b>9.7</b>	<b>15.7</b>	<b>44.0</b>	<b>28.9</b>	<b>-0.6</b>
Net claims on Government	-12.0	-2.3	19.9	1.0	-20.7
Claims on private sector	14.8	6.5	7.9	5.2	15.5
Loans	12.0	9.1	8.2	8.1	12.8
Securities	2.7	-2.6	-0.3	-2.9	2.7
Net external operations <sup>1</sup>	11.3	11.9	22.7	37.3	40.7
BNM	14.2	2.0	5.2	19.9	31.5
Banking system	-2.9	9.9	17.4	17.5	9.2
Other influences	-4.3	-0.3	-6.4	-14.7	-36.1

<sup>1</sup> Pre-revaluation

### M3 continues to expand

M1, or narrow money, a measure of transaction balances, expanded at a slightly slower annual rate of 16.2% at the end of the second quarter (1Q: 17.9%), reflecting mainly slower growth in currency in circulation. Growth in demand deposits remained relatively steady, with continued expansion in placements by businesses and individuals.

M3, or broad money, increased at an annual rate of 12.6% as at end-June (1Q: 14.2%). On a quarterly basis, M3 declined marginally by RM0.6 billion. There was a strong increase in net foreign assets during the second quarter following higher inflows in the form of export proceeds, net foreign investments and portfolio investments. Claims on the private sector also expanded with an increase in loans outstanding as well as higher holdings of private debt securities by the banking system.

Bank Negara Malaysia, through its sterilisation operations, limited the impact of the inflows on broad money expansion. This was achieved through the increased utilisation of Bank Negara Monetary Notes (BNMNs). BNMNs were introduced following the amendments to the Central Bank of Malaysia Act 1958, in late 2006, and is now the key liquidity management instrument.

The effect of Government operations also contributed to the moderation in M3 during the second quarter, as Government deposits with Bank Negara Malaysia increased reflecting the issuance of Government securities as well as tax revenues.

## Higher financing in the second quarter

Gross financing of the private sector through the banking system and capital market was higher in the second quarter, amounting to RM155.7 billion (1Q: RM135.1 billion). This was on account of higher issuance of private debt securities (PDS) and an increase in loan disbursements. The rise in PDS reflected financing for merger and acquisition (M&A) activities in April. On a net basis, banking system loans and PDS outstanding expanded at a higher combined annual rate of 6.8% at end-June (end-1Q: 6.1%).

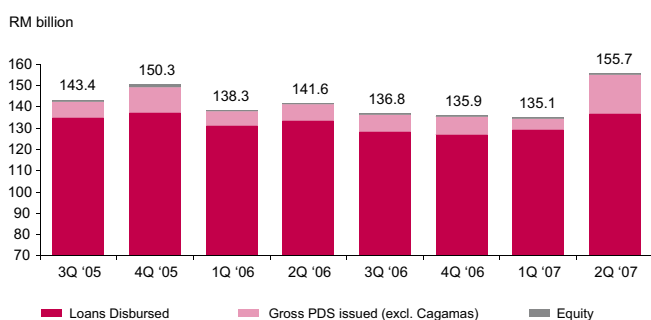
### Financing of the Private Sector through Banking System and Capital Market

	During the period (RM billion)				Annual growth (%)		
	2006	2Q 06	1Q 07	2Q 07*	2006	1Q 07	2Q 07*
<b>Gross total financing</b>	<b>552.6</b>	<b>141.6</b>	<b>135.1</b>	<b>155.7</b>	<b>-2.3</b>	<b>-2.3</b>	<b>10.0</b>
Loans disbursed*	519.9	133.4	129.2	136.7	-1.6	-1.4	2.5
Gross PDS (excl. Cagamas)	30.7	7.8	5.1	18.5	-0.1	-25.5	136.1
Equity	1.9	0.4	0.8	0.5	-69.7	108.5	33.4
<b>Outstanding total financing (A)+(B)</b>	<b>45.4</b>	<b>16.3</b>	<b>11.0</b>	<b>22.7</b>	<b>6.2</b>	<b>6.1</b>	<b>6.8</b>
Banking system	46.7	17.6	9.4	16.5	7.9	7.8	7.4
Loans outstanding (A)	34.9	13.0	8.6	12.5	6.3	6.2	6.0
Holding of PDS	11.8	4.6	0.8	4.0	33.4	32.2	27.2
PDS outstanding (B)	10.5	3.3	2.4	10.3	6.0	5.6	9.4
Memorandum item							
Gross PDS (incl. Cagamas)	38.2	10.8	7.6	21.0	1.8	-28.3	94.5

\* Preliminary

\* Banking system loans include loans sold to Cagamas

### Gross Private Sector Financing through Banking System and Capital Market



Loan applications and approvals were notably higher on an annual basis, driven mainly by the business sector, and to a lesser extent, the household sector. Within the business sector, high loan applications and approvals

during the second quarter were registered mainly in the transport, storage and telecommunications sector. This mainly reflected applications and approvals for financing in May and June under a large syndicated bridging loan facility. In addition, the launch of projects under the Ninth Malaysia Plan also contributed to the higher demand for business loans, mainly to the construction sector and construction related-manufacturing industries, such as iron and steel, non-metallic products and fabricated metals. In the household sector, the increase in loan applications and approvals was mainly on account of loans for the purchase of residential property. The availability of various financing packages offered by the financial institutions and also the abolishment of real property gains tax (RPGT) announced by the Government, are the factors influencing growth in housing loan applications and approvals.

Loan disbursements also increased on an annual basis. By sector, the growth in loan disbursements emanated mainly from the finance, insurance & business services sector, and to a lesser extent, the manufacturing and transport, storage & communication sectors. Of the total loans disbursed, 45% went to large corporations, 30% to households and 25% to SMEs.

Total loans outstanding expanded by 6% on an annual basis at the end of the second quarter (end-1Q: 6.2%), with loans outstanding to businesses and households expanding at annual rates of 6% and 7.2% respectively (end-1Q: 6.2% and 7.6% respectively).

## Loan Indicators

	During the period (RM billion)				Annual Growth %			
	2006	2Q 06	1Q 07	2Q 07 <sup>P</sup>	2006	2Q 06	1Q 07	2Q 07 <sup>P</sup>
<b>Total</b>								
Loan applications <sup>n</sup>	300.8	76.0	83.5	119.5	-1.5	-6.0	21.5	57.2
Loan approvals <sup>n</sup>	188.3	47.5	53.1	83.2	-2.0	0.0	20.4	75.0
Loan disbursements <sup>n</sup>	519.9	133.4	129.2	136.7	-1.6	2.9	-1.4	2.5
Loan repayments <sup>n</sup>	478.2	119.9	118.0	123.0	-2.1	-0.5	-0.1	2.6
Change in loan outstanding*	34.9	13.0	8.6	12.5	6.3	8.6	6.2	6.0
<b>Of which:</b>								
<b>Business enterprises**</b>								
Loan applications <sup>n</sup>	159.8	41.0	44.4	71.7	4.4	0.4	23.3	75.1
Loan approvals <sup>n</sup>	95.3	23.4	29.7	53.7	7.9	15.3	41.2	130.0
Loan disbursements <sup>n</sup>	368.8	94.3	90.0	96.3	-1.6	2.6	-3.9	2.1
Loan repayments <sup>n</sup>	349.9	89.1	81.3	86.6	-4.6	-1.9	-6.2	-2.7
Change in loan outstanding*	9.4	6.2	4.0	6.1	4.2	4.4	6.2	6.0
<b>SMEs</b>								
Loan applications <sup>n</sup>	70.1	18.8	19.9	23.5	n.a.	n.a.	52.8	25.2
Loan approvals <sup>n</sup>	39.1	9.5	10.6	14.2	n.a.	n.a.	40.6	49.0
Loan disbursements <sup>n</sup>	133.2	36.7	32.7	34.8	n.a.	n.a.	11.0	-5.5
Change in loan outstanding*	6.5	2.3	2.8	1.2	n.a.	n.a.	6.2	6.8
<b>Large corporations</b>								
Loan applications <sup>n</sup>	89.6	22.2	24.5	48.2	n.a.	n.a.	6.5	117.4
Loan approvals <sup>n</sup>	56.1	13.8	19.2	39.5	n.a.	n.a.	41.6	185.7
Loan disbursements <sup>n</sup>	235.6	57.6	57.3	61.5	n.a.	n.a.	1.0	-5.5
Change in loan outstanding*	2.9	3.9	1.2	4.9	n.a.	n.a.	6.2	6.8
<b>Households</b>								
Loan applications <sup>n</sup>	141.1	35.1	39.1	47.8	-7.3	-12.6	19.5	36.2
Loan approvals <sup>n</sup>	93.1	24.2	23.4	29.4	-10.4	-11.3	1.3	21.8
Loan disbursements <sup>n</sup>	151.1	39.1	39.2	40.5	-1.7	3.5	4.9	3.5
Loan repayments <sup>n</sup>	128.3	30.8	36.7	36.4	5.6	3.8	16.8	18.0
Change in loan outstanding*	28.7	6.5	3.8	5.6	9.4	13.2	7.6	7.2

\* The annual growth is for end-period

\*\* Following reclassifications under the Financial Institutions Statistical System (FISS) effective April 2006, in order to maintain comparability on an annual basis for loan applications, approvals, disbursements and repayments, the category business enterprises has been expanded to include loans to other customers, namely non-bank financial institutions, Government, domestic non-business entities and foreign entities. These loans account for a relatively small share of the total compared with business enterprises. Trend wise, growth rates remain similar to those under the previous definition

<sup>n</sup> Numbers may not add up due to rounding

<sup>P</sup> Preliminary. Data is subject to revision, arising from changes in the classification of loan indicators by economic sectors and purpose

n.a. Not applicable

Source: Bank Negara Malaysia

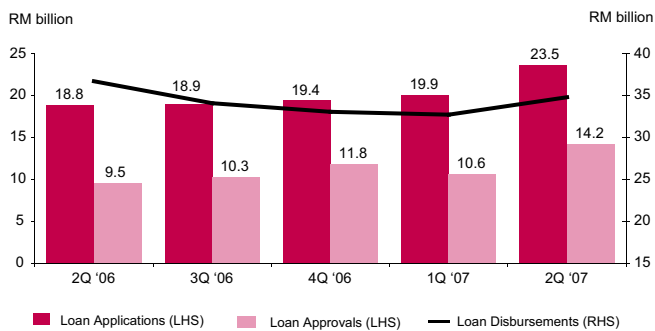
### Loans by Sector

	Loans disbursed				Loans out-standing	
	During the period			Share of total	Share of total	
	2006	2Q 06	1Q 07	2Q 07*		
	RM billion			%		
Business enterprises	368.8	94.3	90.0	96.3	70.4	39.9
<i>Large corporations</i>	235.6	57.6	57.3	61.5	45.0	22.6
<i>SMEs</i>	133.2	36.7	32.7	34.8	25.4	17.4
Households	151.1	39.1	39.2	40.5	29.6	55.8
<b>Selected sectors</b>						
Agriculture, hunting, forestry and fishing	13.9	4.0	3.1	3.3	2.4	2.2
Mining and quarrying	2.0	0.7	0.3	0.6	0.4	0.2
Manufacturing	118.9	29.9	32.5	32.7	23.9	11.5
Construction	30.5	7.9	7.6	8.4	6.1	5.1
Real estates	10.5	3.4	2.4	3.0	2.2	2.9
Electricity, gas and water supply	2.9	0.4	0.3	0.3	0.2	0.6
Wholesale, retail, restaurants and hotels	90.7	25.0	20.5	21.7	15.9	8.6
Transport, storage and communication	10.3	2.8	2.5	4.4	3.2	2.3
Finance, insurance and business services	42.1	9.8	10.3	13.5	9.8	6.3
Consumption credit	100.4	25.8	25.4	25.1	18.3	23.8
<i>Of which:</i>						
<i>Credit cards</i>	48.9	11.2	13.8	13.1	9.6	3.4
<i>Purchase of passenger cars</i>	32.9	8.9	7.2	7.5	5.5	16.1
<b>Total</b>	<b>519.9</b>	<b>133.4</b>	<b>129.2</b>	<b>136.7</b>	<b>100.0</b>	<b>100.0</b>

\* Based on New FISS reporting system

Source: Bank Negara Malaysia

### Bank Lending to SMEs



### Higher fund raising activity in the capital market

During the second quarter, fund raising activity in the capital market was significantly higher. Total net funds raised by the public and private sector amounted to RM22 billion, a sharp increase from the RM9.4 billion raised in the first quarter of 2007.

The bulk of the funds were raised in the private sector, with gross funds raised from private debt securities (PDS) issuances amounting to RM21 billion (1Q: RM7.6 billion). The sharp increase in PDS issuances was mainly due to merger and acquisition (M&A) activities in the electricity, gas and water sector valued at RM7.3 billion. In addition, there were several PDS issuances by special purpose vehicles (SPV). On a net basis, the funds raised through the PDS market, excluding Cagamas, amounted to RM12.4 billion (1Q: RM2.5 billion).

The public sector raised total gross funds amounting to RM12.6 billion mainly from four issuances of Government securities. This includes an issuance of 20-year Malaysian Government Securities (MGS), the re-opening of a 5-year MGS and an issuance of 10-year Government Investment Issues (GII). After adjusting for redemptions, the net funds raised by the public sector were higher than in the previous quarter, amounting to RM10.7 billion (1Q: RM7.4 billion).

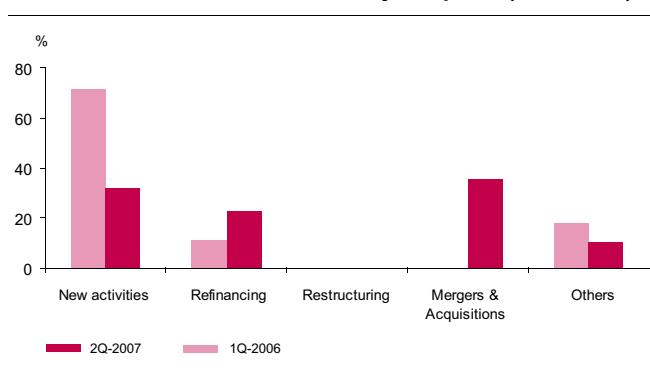
In the equity market, the funds raised during the second quarter decreased to

#### Funds Raised in the Capital Market

	2005	2006		2007		
	Year	1Q	2Q	Year	1Q	2Q
RM million						
<b>By Public Sector</b>						
Government Securities, gross	28,276	5,265	5,741	26,830	10,109	9,107
Less Redemptions	15,800	500	1,300	12,850	4,800	-
Less Government holdings	-	-	-	-	-	-
<i>Equals</i> Net Federal receipts	12,476	4,765	4,441	13,980	5,309	9,107
Khazanah Bonds, net	833	(1,700)	-	(630)	(1,020)	524
Govt. Investment Issues, net	1,000	-	3,500	9,500	3,500	1,400
Merdeka Savings Bond, net	1,516	(500)	(502)	(1,931)	(358)	(375)
Net Funds Raised	15,825	2,564	7,438	20,919	7,431	10,657
<b>By Private Sector</b>						
Shares	6,315	381	384	1,916	795	512
Debt securities	38,196	10,574	10,784	38,887	7,582	20,971
<i>Private Debt Securities (PDS)</i>	35,656	6,889	8,819	31,737	6,232	20,571
Cagamas	2,540	3,685	1,965	7,150	1,350	400
Less Redemptions	18,617	5,498	7,684	31,519	6,390	10,038
Net Issues	19,579	5,076	3,099	7,368	1,192	10,934
<i>Net issues (excluding Cagamas)</i>	22,224	2,993	3,314	11,120	2,547	12,379
Net Funds Raised	25,894	5,457	3,484	9,284	1,987	11,446
<b>Total Net Funds Raised</b>	<b>41,719</b>	<b>8,022</b>	<b>10,922</b>	<b>30,203</b>	<b>9,418</b>	<b>22,103</b>
Short-term Papers and Notes, net <sup>1</sup>	1,579	1,312	1,175	2,563	599	1,164
<b>Total</b>	<b>43,297</b>	<b>9,334</b>	<b>12,097</b>	<b>32,766</b>	<b>10,017</b>	<b>23,265</b>

<sup>1</sup> Refers to Commercial Papers and Cagamas Notes only

#### Private Debt Securities Issued by Purpose (% of total)

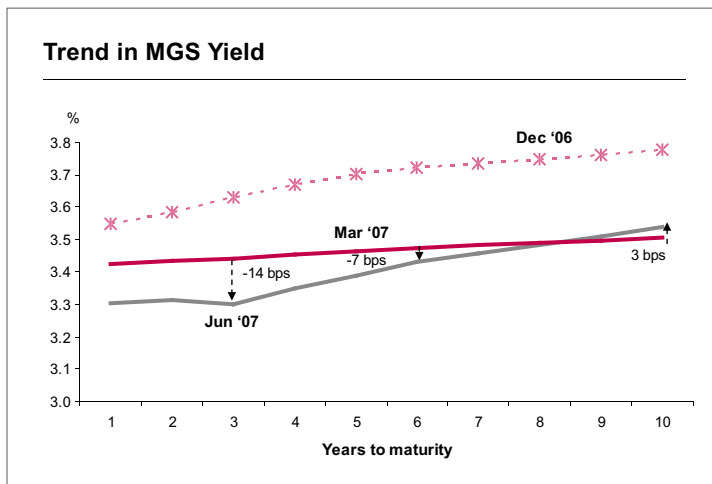
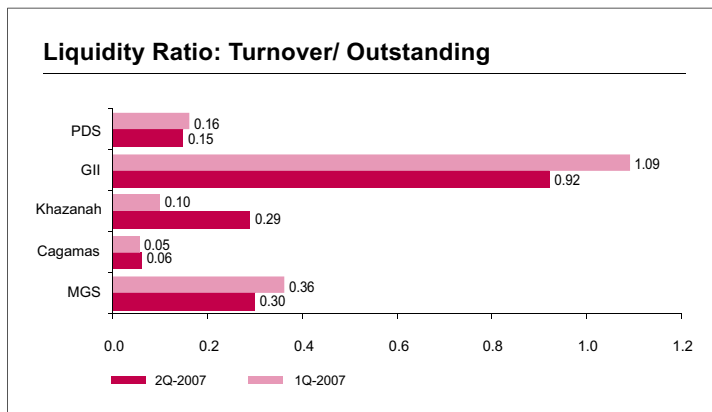


RM512 million (1Q: RM795 million). The funds were raised through seven initial public offerings (IPOs) amounting to RM512 million. During the quarter, eight new listings were recorded on Bursa Malaysia; five on the main board and three on the Second Board. Most of the listings were from the services and consumer products sector.

## Secondary trading in the bond market

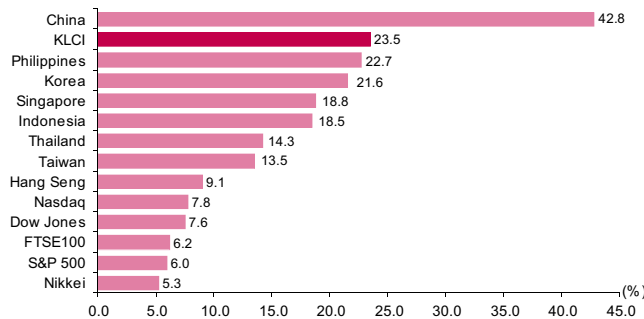
Total trading in the secondary market amounted to RM110.6 billion in the second quarter (1Q: RM120.2 billion). The bulk of the trades were in Government Securities (MGS and GII), accounting for 70% of total trades, followed by private debt securities, which accounted for 27% of total trades. In terms of liquidity, the GII continues to be the most liquid paper, registering a liquidity ratio of 0.92, followed by the MGS with a liquidity ratio of 0.30.

MGS yields went through a volatile period during the quarter. Between early April to early May, bond yields were seen declining between 9 – 16 basis on expectations of capital inflows following the announcement of equity and property market liberalization measures by the government. Speculation on an easing of monetary policy following the release of lower export and industrial production number, pushed yields lower by as much as 37 basis points during the first three weeks of May.



However, Bank Negara Malaysia's decision to keep the OPR unchanged at the May Monetary Policy Committee (MPC) meeting, in combination with the global bond market sell-off in June, MGS yields trended upwards between 41 – 67 basis points. Nonetheless, at the end of the quarter, yields on MGS across all maturities up to 8-years were still lower than their levels in the previous quarter, with the 3-year and 5-year MGS lower by 14 and 7 basis points respectively. The 9-year and 10-year MGS yields rose slightly, with the 10-year MGS higher by 3 basis points. As a result, the yield curve became upward sloping again towards the end of the quarter.

**Performance of Selected Global and Regional Markets (29 Dec 2006 - 29 June 2007)**



**The KLCI improved further in the second quarter**

In the second quarter of 2007, the KLCI performed strongly in line with regional markets despite rising global interest rates. The local market was supported by strong economic fundamentals and positive developments within the plantation and property sectors such as the record high crude palm oil prices and announcements

**Bursa Malaysia: Turnover of Corporate Securities**

	2006				2007					
	2Q		1H		1Q		2Q		1H	
	million units	RM million	million units	RM million	million units	RM million	million units	RM million	million units	RM million
Turnover	57,775	68,662	103,763	122,333	118,982	156,614	88,297	141,623	207,279	298,238
Of which:										
Main Board	36,340	54,879	62,905	97,623	87,148	137,851	61,617	125,411	148,766	263,262
Of which										
Consumer Products	1,320	4,245	3,128	9,079	1,796	4,695	2,020	5,052	3,816	9,748
Industrial Products	5,201	5,432	8,347	8,565	8,771	11,725	7,773	11,161	16,544	22,887
Construction	3,676	4,799	6,724	7,919	7,469	16,864	5,080	12,734	12,550	29,598
Trading/Services	8,855	19,699	15,046	34,684	20,181	44,458	16,266	43,536	36,447	87,993
Finance	3,218	9,562	5,929	18,608	8,846	28,428	5,530	21,173	14,377	49,601
Properties	7,090	2,928	11,196	4,968	16,381	11,369	12,125	13,277	28,506	24,646
Plantations	782	4,118	1,301	6,826	1,341	8,318	2,064	10,689	3,405	19,007
Infrastructure	1,048	2,103	2,061	3,705	1,539	3,231	943	2,335	2,481	5,567
Second Board	6,792	5,304	12,629	9,835	8,527	4,955	11,000	7,903	19,527	12,858
Mesdaq	14,188	8,205	27,625	14,493	17,050	8,386	9,704	6,150	26,755	14,537

Source: Bursa Malaysia

**Bursa Malaysia: Selected Market Indicators**

	As at end				
	2006		2007		
	2Q	1H	1Q	2Q	1H
Price Indices					
Composite	914.7	914.7	1,246.9	1,354.4	1,354.4
FBM30 <sup>1</sup>	5,919.4	5,919.4	7,924.6	8,587.9	8,587.9
FBMEMAS <sup>2</sup>	5,973.7	5,973.7	8,332.8	9,107.9	9,107.9
Second Board	93.7	93.7	99.3	110.7	110.7
Mesdaq	118.9	118.9	138.5	137.7	137.7
Average daily turnover					
Volume (million units)	931.9	857.5	1,983.0	1,427.5	1,700.7
Value (RM million)	1,107.5	1,011.0	2,610.2	2,298.4	2,451.7
Market capitalisation (RM billion)	721.8	721.8	985.1	1,088.3	1,088.3
No. of companies listed	1,026	1,026	1,023	1,012	1,012

<sup>1</sup> FBM30 stands for FTSE Bursa Malaysia 30 Index

<sup>2</sup> FBMEMAS stands for FTSE Bursa Malaysia Emas Index

Source: Bursa Malaysia

of several privatisation deals. In addition, the announcement of a pay rise for civil servants and favourable domestic corporate earnings results in the first quarter were also positive on the market. During the quarter under review, the KLCI rose 8.62% and ended the quarter at 1,354 points (1Q: 1,247). Market capitalisation was higher at RM1,088.3 billion (1Q: RM985.1 billion). However, trading activity decreased with the average daily turnover of 1,427.5 million units (1Q: 1,983 million units).

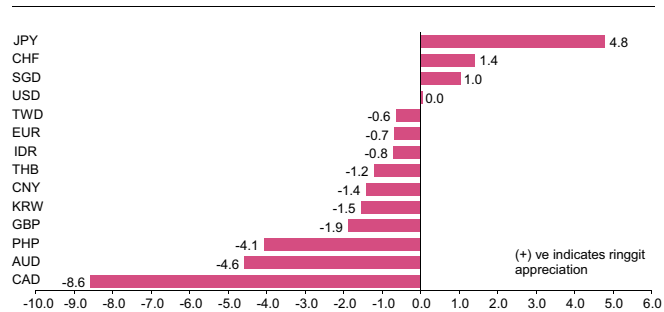
As at 28 August 2007, the KLCI closed higher at 1,278.9 points (since end-2006: +16.7%) with market capitalisation higher at RM988.1 billion (since end-2006: +16.4%).

### Exchange Rate Developments

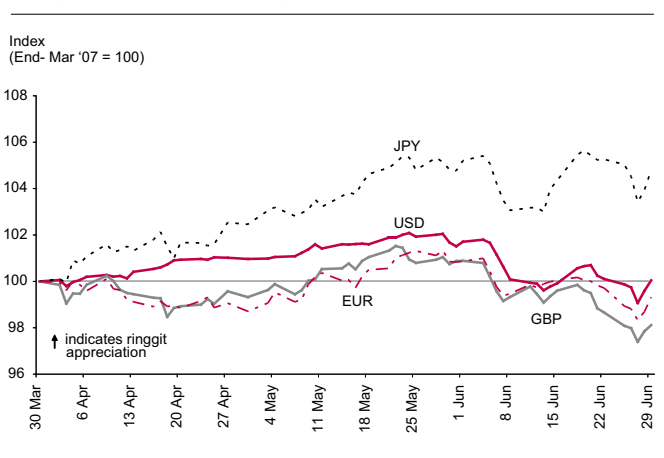
Amidst two-way trade and investment flows, the ringgit continued to strengthen against the US dollar going into the second quarter, appreciating by about 2% until end-May. The turbulence in the global financial markets triggered by developments in the subprime market in the US in July however culminated in the weakening of regional currencies, including the ringgit against the US dollar. Thus, following an extended period of appreciation since the beginning of the year, the ringgit depreciated with other regional currencies against the US dollar. Nevertheless, for the second quarter as a whole the ringgit was relatively unchanged against the US dollar. Against other major currencies, the ringgit weakened marginally against the pound sterling (1.9%) and euro (0.7%), but strengthened against the Japanese yen (4.8%). Against the regional currencies, the ringgit broadly depreciated in the range of 0.8% - 4.1%, the exception being an appreciation against the Singapore dollar (1%).

For the period 1 July – 28 August, the ringgit depreciated against the major and regional currencies in the range of 0.2% - 7.5%, the exception being an appreciation against the Indonesian rupiah (2.7%) and Korean won (0.4%).

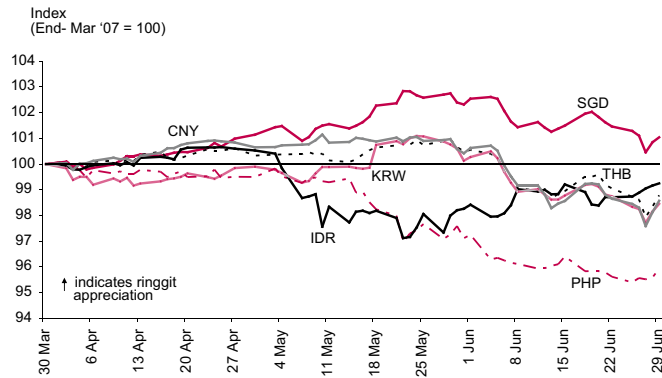
**Summary of Ringgit Performance Against Selected Currencies** Percent Change (1 April - 29 June 2007)



**Ringgit Performance Against Major Currencies**



### Ringgit Performance Against Regional Currencies



### Performance of Ringgit Against Selected Currencies

RM per foreign currency	As at end				% change since*		
	21 Jul 05	2Q 06	1Q 07	2Q 07	21 Jul 05	2Q 06	1Q 07
US dollar	3.8000	3.6750	3.4560	3.4545	10.0	6.4	0.0
Euro	4.6212	4.6698	4.6105	4.6425	-0.5	0.6	-0.7
Pound sterling	6.6270	6.7352	6.7867	6.9171	-4.2	-2.6	-1.9
100 Japanese yen	3.3745	3.1963	2.9339	2.8000	20.5	14.2	4.8
Singapore dollar	2.2570	2.3126	2.2781	2.2547	0.1	2.6	1.0
100 Thai baht	9.0681	9.6104	9.8785	10.000	-9.3	-3.9	-1.2
100 Philippine peso	6.8131	6.9047	7.1649	7.4692	-8.8	-7.6	-4.1
100 Indonesian rupiah	0.0386	0.0395	0.0379	0.0382	1.1	3.5	-0.8
100 Korean won	0.3665	0.3856	0.3674	0.3732	-1.8	3.3	-1.5
Chinese renminbi	0.4591	0.4598	0.4471	0.4535	1.2	1.4	-1.4

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

## DEVELOPMENTS IN THE BANKING SECTOR

The banking system continued to exhibit high resilience in the second quarter of 2007, supported by strong capitalisation and improved profitability. At the same time, lending activities continued to grow amidst further improvement in loan quality.

### Capitalisation level remained strong

The banking system remained well-capitalised with the risk-weighted capital ratio (RWCR) sustained above 13% throughout the quarter. As at end-June 2007, although the RWCR remained at 13.1%, the capital base expanded by 3.1%, mainly due to issuance of subordinated debt capital by two banking institutions.

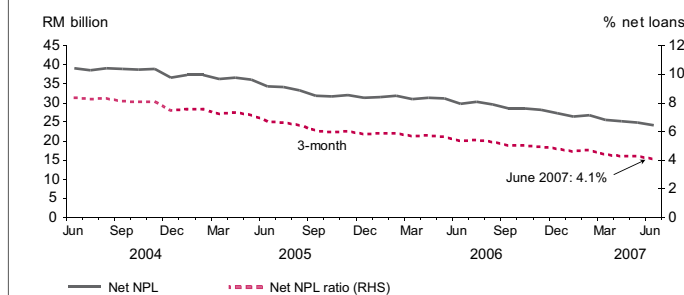
#### Banking System: Capital Position

	2006			2007	
	2Q	3Q	4Q	1Q	2Q
Capital					
CCR (%)	10.0	10.5	10.7	10.4	9.9
RWCR (%)	12.8	13.3	13.5	13.1	13.1

### Profitability improved on account of higher income

The pre-tax profit of the banking sector registered a strong growth of 17.6% to RM4.5 billion (1Q: RM3.8 billion). The favourable

#### Banking System: Non-performing Loans



performance was attributed mainly to higher income derived from both interest related activities (+RM0.4 billion or 5.6%) and fee-based activities (+RM0.2 billion or 9.2%). Consequently, the annualised return on average assets and equity improved to 1.5% and 18.8% (1Q: 1.4% and 17.4%) respectively.

### Continued downtrend in NPLs

The level of non-performing loans (NPLs) continued to improve with the total net NPLs based on the 3-month classification declining by 6.1% to RM24.1 billion (1Q: RM25.6 billion) as at end of the quarter. The improvement was attributed primarily to higher recoveries (+9%) and reclassifications of NPLs to performing status (+15.5%) as well as continued write-offs. Given the continuous improvement in loan quality, the net NPL ratio declined further to 4.1% of net total loans (1Q: 4.4%).

**4th IFSB Summit: “The Need for a Cross-Sectoral Approach in  
Supervision of Islamic Financial Services”  
15 May 2007, Dubai, U.A.E.**

by

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

Your excellencies, distinguished guests. While having to urgently leave Dubai, I am not here in person, but most certainly I am here in commitment to the Islamic finance agenda. It is my honour to speak at this 4th IFSB summit hosted by the Central Bank of United Arab Emirates. The theme of the summit on “The Need for a Cross-Sectoral Approach in Supervision of Islamic Financial Services” suggests that a concerted and coordinated effort is needed to ensure financial stability in the Islamic financial system and to strengthen its role as a viable form of contemporary financial intermediation. The issue before us is how this cross sectoral approach is adopted so as to contribute towards increased global financial stability.

***I. Dynamism of Islamic finance enriches the global financial architecture***

The significant growth of Islamic financial markets, the development of the supporting financial infrastructure and the standardised international prudential rules and regulations that are being issued by the Islamic Financial Services Board (IFSB) have considerably strengthened the international Islamic financial architecture, thus contributing towards ensuring the stability and soundness of the Islamic financial industry. The theme of this summit reflects the continuous attention being directed towards this important aspect in the development of Islamic finance.

***II. Impact of “convergence” on market development and supervisory framework***

The unprecedented process of convergence and the transformation in the financial

industry in this recent decade has constantly reshaped and reconfigured the landscape of the financial sector both domestically and internationally. Disintermediation and the blurring of traditional sectoral boundaries between the banking, insurance and the securities industries are among the trends in the financial services industry. Driven by the pressure for efficiency, the convergence has been along several dimensions, including among the different types of financial institutions and across different national jurisdictions. While it has increased the value proposition for consumers, it poses new challenges for the supervisors in the course of ensuring the safety and soundness of the overall financial sector. These challenges range from ensuring adequacy of the surveillance framework, addressing the complexity in assessing the quality of risk management practices, minimizing the potential for regulatory arbitrage, to meeting the demands for consistent supervisory responses within and across jurisdictions.

Given the significant implications of convergence on the market development and supervisory framework, this aspect needs to be addressed for the rapidly evolving Islamic financial services industry. In most jurisdictions, Islamic financial institutions have evolved within the framework and parameters of the conventional system. It has however essentially required constant enhancement of the supervisory regime to ensure that it adequately addresses the risks that are specific to Islamic financial transactions. This becomes important for a contract-based system in Islamic finance, where the financial transactions by the financial institutions in the respective sectors often share common underlying contracts with comparable risk profiles being subject to separate sets of

rules of the different respective financial sectors. This is evident in the efforts to maximize the competitive advantage of the Islamic finance in relation to the concept of profit and risk sharing. The application of this concept in the deposit taking activity of the Islamic banking institutions could conceptually result in a risk profile that resembles that of an Islamic fund manager and that of the securities market players. It involves a similar degree of fiduciary risk on the Islamic financial institutions in ensuring that the investment deposits funds are managed in the most effective and efficient manner. An unlevelled playing field could thus arise if different prudential rules in the areas of capital adequacy requirements, risk management practices, market conduct and rules of financial disclosure, transparency, governance and the Shariah framework are imposed solely based on traditional sectoral boundaries. It is therefore important to ensure that such similar risk profiles and regulatory issues are addressed in a consistent manner across sectors so as to maintain a healthy competition and so as to avoid any potential for regulatory arbitrage.

### ***III. Towards optimal efficiency of a cross sectoral supervisory approach***

In recognizing the relevance of a cross sectoral approach for the supervision of the Islamic financial services industry, allow me to discuss three strategic issues that are key to charting the way forward for achieving optimal efficiency of a cross sectoral supervisory approach.

**Firstly, is the need for greater focus to be given to arrive at common vision on the future landscape of the Islamic financial services industry.** Clarity of the parameters of the scope and nature of business activities of the financial institutions and financial markets is paramount in achieving the objective of financial stability. Within the current Islamic financial landscape, across jurisdictions, there exist however disparities and a perceived lack of clarity in

the specific scope and nature of the Islamic financial services that are permitted within each respective sector. The challenge for supervisors has been to formulate a comprehensive supervisory framework that adequately addresses the respective risk exposures for the Islamic financial institutions. Islamic banking institutions in Malaysia may for example have different parameters on the scope of business and permitted activities in comparison to Islamic banking institutions in other jurisdictions. This may result in a disparity in understanding among sectoral regulators and the industry players on the scope of business activities of Islamic financial institutions in different jurisdictions. There is therefore a need to be on the same wavelength within and across jurisdictions on the nature and scope of business activities of an Islamic banking institution, takaful operator or Islamic capital market player to serve as a guide for the orderly development of the industry. In essence, the structured development of the industry that is able to meet the new demands of the environment and to address the newly emerging challenges is critical to ensure sustainable development of the Islamic financial services industry.

A recent joint effort by the Islamic Development Bank and the Islamic Financial Services Board has laid the foundation to achieve this objective with the impending issuance of the Ten-Year Strategy and Plan for the Development of Islamic Financial Services Industry and the establishment of the Standing Committee to oversee its implementation. The formulation of the ten-year master-plan for the Islamic financial services industry marks an important step in setting the blueprint for leading the development of Islamic finance in a structured and synchronized manner across jurisdictions to achieve the common goal of a vibrant and comprehensive Islamic financial system. This document will provide a framework for the national authorities to put in place a strategic plan for an orderly development of the Islamic financial services industry and thus facilitate greater understanding of the nature of the cross sectoral supervisory approach that is required.

**This brings me to the second issue relating to the need for a more collaborative effort to be garnered among the financial supervisors.** A structured collaboration among supervisors across sectors would provide a framework for rationalizing the key policies across sectors and allow for more efficient supervision of the Islamic financial institutions. Inter-agency coordination is important to address the common risks across sectors not only through the sharing of information, but also through the harmonization of prudential and market conduct rules, the adoption of consistent Shariah governance framework and the setting up of a comprehensive shared safety net. A structured collaborative approach for consultation on issues of common interest rather than ad hoc coordination would be more effective in addressing events such as crisis management and the effect of systemic contagion. A strong collaborative culture would contribute towards the development of more consistent rules and their application across sectors while leaving the discretion to each jurisdiction to determine the most appropriate supervisory model to be adopted based on the context and distinct environment of its own respective sector.

In Malaysia, a cumulative and comprehensive cross sectoral development strategy has been adopted from the inception of Islamic finance. Legislation covering Islamic banking, takaful and the capital market activities were enacted more than two decades ago to provide the legal and regulatory framework of Islamic financial services industry. A consistent Shariah governance framework is also in place for the Islamic financial industry. There is also a common membership of the Shariah Advisory Council at Bank Negara Malaysia and the Shariah Committee at the Malaysian Securities Commission to achieve coordination between the sectoral supervisors. The inter-agency collaboration has also been formalized with the execution of a Memorandum of Understanding between

Bank Negara Malaysia and the Securities Commission. The recent formation of a high level inter-agency Executive Committee has also elevated further the collaborative arrangements to a wide involvement. The Committee comprises a high-level group of top officials from the key relevant Ministries, Government departments and agencies, financial and market regulators and the representatives from the banking, takaful and capital market sector. Through having a shared vision and commitment, this Committee is responsible for undertaking a review of all policies relevant for the comprehensive development and promotion of Islamic finance.

In Malaysia, Bank Negara Malaysia is mandated with the responsibility to oversee the operations of monetary policy and to safeguard the financial stability of the financial system. It is in this context that the overall management of the Islamic financial services sector remains within the functions of Bank Negara Malaysia. The Islamic financial services sector requires specific focus in the aspect of regulation and supervision of its contractual nature and unique characteristics of Islamic finance that has greater involvement of the Islamic financial industry in the real economic sector through the principles of murabahah, musyarakah and mudarabah in the Islamic financing contracts. In this regard, the management of risks in Islamic finance requires a different set of techniques and expertise. In reality, the contractual nature of Islamic finance has implications for monetary policy in terms of credit creation and in relation to the rate of return or asset yield. As such, the overall impact of this on the Islamic financial system and monetary policy has reinforced the taking on of these important mandates - a case of upholding the form rather than the structure, given this relationship between financial stability and the operations of monetary policy. To further reinforce this framework, the Central Bank in Malaysia has shifted from a sectoral

regulatory approach, to one that integrates the Bank's regulation of the different financial institutions under its purview along functional lines to better position the Bank to ensure financial stability in the overall system.

**The third issue relates to global coordination which is key to the efficient supervision of the Islamic financial industry as its international dimension gains significance and as it becomes an integral part of the international financial system in an increasingly globalized environment. This can be achieved by leveraging on the existing international infrastructure and enhancing collaboration in the working arrangements.**

Best practices and rules in the financial services industry have been influenced by the international standards of the International standard setting bodies such as Bank for International Settlement (BIS), Islamic Financial Services Board (IFSB), International Association of Insurance Supervisors (IAIS) and International Organization of Securities Commissions (IOSCO) and the international accounting standards setting entities that are all aimed at ensuring best practices in the financial industry. There needs to be however a degree of consistency of the rules that are applicable in the international financial system. The efforts of the Joint Forum of the Basel Committee, IAIS and IOSCO in addressing the cross sectoral issues, such as the similarities and differences of the core principles ( i ), and in the cross sectoral regulatory and market differences ( ii ), have set the foundation for achieving such consistency in the rules across sectors at the international level.

For the Islamic financial services industry, the comprehensive mandate of the IFSB that covers the major components of the financial sector and the broad-based membership comprising the regulators and industry players of the respective sectors

presents a platform for achieving such cross sectoral consistency. In undertaking its core role to promote prudent, transparent and the robust development of the Islamic financial services industry through the promulgation of international prudential standards, the IFSB with its wide network membership across sectors from more than 20 countries is well positioned to ensure that cross sectoral issues are rigorously addressed. The on-going work by dedicated working groups on the standards for corporate governance for the takaful industry and the industry-wide Shariah governance framework are a manifestation of the broad mandate of the IFSB that transcends beyond the banking industry. In addition, the IFSB, through its linkages with other international bodies that includes the International Monetary Fund, Bank for International Settlements, AAOIFI, IAIS and IOSCO, will be able to create synergies in the future development of the international standards for Islamic finance. Greater engagement and collaboration would build the foundation for enhancing the understanding of the dynamics of the inter-linkages that is important in the sound development of Islamic finance.

The strong collaboration among supervisors is also important to address the home-host issues in cross border Islamic financial services. The application of consistent rules across jurisdictions, such as in the implementation of capital standards for Islamic financial services, will facilitate the orderly global development of Islamic finance. The IMF, together with the World Bank in initiating the formation of the Joint Forum, have a potentially significant role in facilitating the cross sectoral initiatives for the Islamic financial services industry. Within the context of the Financial Sector Assessment Program, encouragement can also be provided for the adherence and implementation of the IFSB standards and rules across jurisdictions along with the core principles and standards of the Basle Committee, IAIS and IOSCO. This would indeed contribute towards the efforts

of achieving global financial stability in the international Islamic financial system.

#### ***IV. Conclusion***

Let me conclude my remarks. Aligning cross sectoral approaches is a key part of the process of building a viable and sustainable Islamic financial system. Efforts therefore need to continue to strengthen the international Islamic financial architecture

and to enhance international cooperation and collaboration in addition to developing a strong domestic supervisory framework to deal with the changing configurations of a highly dynamic and rapidly evolving environment. It is our hope that this summit will contribute towards building greater collective efforts through multi-stakeholder deliberations and networking activities to improve our understanding on the cross sectoral issues in Islamic finance.

**Malaysia-Indonesia Investment & Finance Summit  
18 June 2007, Jakarta, Indonesia**

**“Enhancing Financial Integration in the New Nusantara”**

**Luncheon Address by**

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

There has been a long history that transcends several centuries in which international trade flourished in the Malay archipelago. The South East Asia region contained the important maritime routes for the trade between the East and West. This had brought with it, robust economic growth and regional prosperity.

Today, the South East Asian region—the Nusantara region continues to be one of the world’s most dynamic regions. Since the turn of this century, our economies have re-emerged to be amongst the fastest growing in the global economy, amidst new challenges and fundamental economic and financial developments. Our steadfast reform and restructuring efforts have rewarded us with strengthened macroeconomic fundamentals and sound and stable financial systems. These efforts continue to be augmented by the strong foundations that the region possesses, namely abundant natural and human resources, high savings rates and the ingrained aptitude to persevere and rise to the challenge.

The ASEAN 5 group of economies that includes Indonesia, Malaysia, the Philippines, Thailand and Singapore have now for an extended period of time been on a steady growth path.

A more recent phenomenon in this decade, has been the increased economic and financial linkages within the region spurring further regional economic and regional financial integration. The geographical proximity and cultural similarities have been reinforced by the diverse strengths

that exists in the region. These factors have been important in enhancing the integration process.

As this greater regional economic and financial integration is advanced, it will serve as a powerful catalyst for the future expansion of intra-regional trade and investment, creating a self-sustaining and mutually reinforcing economic growth in the New Nusantara region.

It is my pleasure today to speak on the potential role of an integrated economic and financial platform within the Nusantara region, a region of rapid economic growth in which almost 300 million Muslims resides. My remarks will focus on the potential generated by a collaborative platform and the significance of building linkages between the Nusantara region with other parts of the world.

The region’s current economic progress, prosperity and financial stability has now accorded us a new strategic window of opportunity to develop new value propositions to unleash the full potential accorded by the accelerating economic and financial integration process. There are already encouraging formal and informal inter linkages between our respective financial markets as well as a higher level of engagement between the respective corporate communities, the market participants and the authorities.

A collaborative platform that is based on the diverse comparative advantages of the Nusantara economies can benefit from the complementarities between our respective economies. Essentially, these opportunities

will increase the potential to expand markets, increase products lines and deepen the research and development capabilities. In this regard, the emergence of Islamic finance into the mainstream of the financial system is an opportunity for the Nusantara financial intermediaries, in particular, for Malaysia and Indonesia and other neighbouring countries, to open new frontiers and in so doing strengthen further the economic and financial linkages.

The building of a Nusantara financial platform would not only facilitate and mobilise the pool of investable funds from the respective economies but also allow for the more efficient allocation of the funds into the productive investments in other parts of the region. This would not only contribute towards lowering the cost of funds but it would also allow for greater diversifications of risks.

More recently there has been growing interest in cross border participation in investment activities in our respective economies. Malaysia's capital inflows into Indonesia has increased by three-fold totalling USD2.2 billion in 2006 compared to the previous year. It is estimated that Indonesia requires approximately an annual investment of USD22 billion for the next several years for the development of its infrastructure, with a large part of the funding to be provided by the private sector. In the same way, the Ninth Malaysia Plan for the period of 2006 to 2010 has a financing requirement of RM107.6 billion. The development of our regional financial intermediaries and markets will facilitate the mobilisation of resources towards financing these potential activities and thus contribute to sustaining development in the Nusantara economies.

The profound changes in the global economic and financial environment, has created a greater urgency for the Southeast Asian markets to achieve a greater degree of financial integration. This is so as to

provide the scale and increased efficiency of the financial intermediation process. As the ASEAN economies move towards the formation of an economic-bloc by 2015, the pace of financial integration will need to accelerate, to better facilitate achieving this goal. The wide spread distribution of innovative hybrid financial products and regional cross selling activities will however increase the multi-dimensional dynamics of the markets and the risks across national borders. There will be increased complexity in identifying the risks which will in turn complicate the process of risk management. The increasingly integrated and liberalised markets will also expose our porous economies to greater external influences and to contagion risks. A higher level of vigilance is thus required to allow for pre-emptive policy measures in a timely manner. This will require adequate levels of cooperation among the regional regulators in addressing potentially contagion systemic risks and ensuring regional financial stability.

The deepening of co-operation between the Nusantara's monetary and regulatory authorities is thus a key factor in the development of a robust integrated platform. Enhanced cooperation will promote greater resilience and reduce regional vulnerability to external developments. There are now various regional mechanisms in place to undertake regional surveillance, to facilitate the exchange of information, to enter into greater engagement on issues affecting the region and in developing regional financial markets. In addition, frameworks for enhanced regional risk management, crisis management and resolution are also being put in place.

With greater financial integration, the region will be able to leverage on the advantages of economies of scale, innovation and more importantly place greater reliance on the cumulative strengths that resides within the region including our financial resources, skills and knowledge. It will also better

position the region to collectively address emerging issues and challenges faced by the region taking into consideration the region's socio-economic context.

While Islamic finance is gaining global interest and acceptance, the world's most populated Muslim region in the world, the New Nusantara offers opportunities for the accelerated expansion of Islamic finance. The intrinsic nature of Islamic financial structures encourages stability. Islamic principles require that the financial transaction be supported by genuine economic transactions. To further reinforce this, the governing Shariah principles also serve as a built-in self-regulatory mechanism that insulate Islamic instrument issuers from unproductive, speculative and unethical elements and thereby contributes to the stability of the financial system.

Historically, capital financing and investment flows into the Nusantara region have generally been sourced from the developed financial markets. While we may see continued growth in short term capital inflows from these traditional sources, the more competitive global environment provides no assurance of the sustainability of such longer term investment flows. Meanwhile, our own South East Asian region and that of North Asia and the Middle East countries continue to have high surplus savings seeking opportunities for investment and new asset-classes for greater risk diversification and improved returns on their investments.

Hundreds of years ago, the ports of Nusantara were destinations for the spice trade to Europe via India and the Middle East. In this context, Islamic finance can serve as a bridge that links the Nusantara region to the capital surplus economies. Already, our financial institutions are venturing to have a presence in the Middle East and we welcome their presence in our financial system. This has now in fact resulted in the cross-pollination of talents and resources, giving rise to innovative

products and services, creating depth and breadth to the respective financial markets.

Just as the Straits of Malacca served as an important maritime conduit for the Nusantara region, Malaysia and Indonesia has the potential to serve as an important intermediary for mobilising capital to meet the requirements of the Nusantara region, and to be a distribution centre for shariah compliant securities and to extend the regional Islamic capital markets to other parts of the world. Of importance will be our joint efforts to promote the standardisation of the Islamic regulatory and compliance matters. In relation to this, Malaysia and Indonesia is already working jointly to promote research capabilities and the pool of talent and technical expertise in Islamic finance.

A critical success factor for the cross-border promotion of Islamic finance is the harmonisation of the governing shariah frameworks between our jurisdictions. In this regard, Indonesia's extensive history of scholarly achievement in the subject matter relevant to the principles of Islamic finance can be leveraged upon for the benefit of the region. We are most hopeful for substantive convergence of interpretation and application of the shariah laws and guidelines for the region. The greater collaborative engagement between our respective scholars would indeed facilitate the process.

The large gathering of senior representatives of the public and private sectors here today hints to the significant interest to capitalise on potential of the Nusantara economies. The efforts of the private and public sectors in building a collaborative platform as a resilient base for a network of linkages to the wider world, with God's grace, insyallah, will contribute to advancing the Nusantara Agenda that would unleash the potential of the region for a greater shared prosperity.

**Sukuk Summit 2007: “The Challenge for a Global Islamic Capital Market:  
Strategic Developments in Malaysia”  
20 June 2007, London**

Keynote Address by

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

It gives me great pleasure to be here in London to speak at this landmark sukuk summit. The Islamic bond market - the sukuk market - represents a key component of the Islamic financial system. This recent decade has seen the accelerated development of this market and its significant role in strengthening the evolution of Islamic finance. The global development of this market is particularly important in this more challenging financial and economic environment. It has contributed to enhancing the effectiveness and efficiency of the mobilisation and allocation of funds within national financial systems and in the international financial system. This development is also evidenced by the level of innovation and sophistication of the products and services being offered by the Islamic financial institutions. The encouraging development of the Islamic bonds market has also had an important role in enhancing the linkages between financial markets as it facilitates cross-border flows in the international financial system.

The sukuk market as an important source of financing for large scale investment projects, has a key role in facilitating the economic development process. For investors, it provides greater potential for diversification into new asset classes. My remarks today will focus on the vast potential of the Islamic bond market in the economic development process, in its role in ensuring financial stability and its role in promoting greater financial integration in the global financial system. I would also like to take this opportunity to share with you Malaysia’s experience in the development of this market. The Malaysian sukuk market has now evolved into one of the world’s largest Islamic bond market.

***Immense role of sukuk market in the economic development***

The financing requirements for economic development are immense. The bond market is key to meeting these funding needs for both the public and private sectors. This is particularly important for emerging market economies. In the Middle East and in Asia, two of the fastest growing regions in the global economy are taking place following privatisation and implementation of infrastructure projects. Asia alone will be spending an estimated USD1 trillion on infrastructure over the next five years, while infrastructure requirements in the Middle East are estimated to be USD500 billion over the same period. The challenge is to put in place an intermediation system that will channel the surplus savings in both these regions into productive investments. It is in this context that the Islamic capital market, in particular the sukuk market will serve as an important avenue to efficiently mobilise longer term funds to meet these funding requirements.

The global experience has shown that the lack of well developed bond markets brings with it vulnerabilities arising from over-reliance on financing from the banking sector. This has often resulted in funding mismatches with adverse implications on financial stability. The development of the bond market allows for access to funding with the appropriate maturities, thus avoiding the funding mismatches. It also allows for the diversification of risks by issuers and investors.

The central merit of the sukuk structure is that it is based on real underlying assets. The *ijarah* sukuk for example - an Islamic

bond which applies a sales and leaseback arrangement - is an asset-backed instrument providing continuous security to the investor. This approach discourages over-exposure of the financing facility beyond the value of the underlying asset, given that the issuer cannot leverage in excess of the asset value.

In addition, Islamic finance requires that the financing must be channelled for productive purposes, such as for project financing, rather than for speculative activities. The risk exposure is therefore to the project and not to the uncertainties or activities that have no real economic benefits. Islamic financial intermediation therefore has the potential role of contributing towards financial stability.

In the current environment, the demand for sukuk significantly exceeds the supply. Today, the global sukuk market, denominated in international currencies, is estimated to be USD18 billion. If domestic sukuk issuance is included, it has now exceeded USD50 billion. Although the size of the market may seem modest by global standards, the sukuk market has been registering an impressive average growth of 40 per cent per annum. The phenomenal demand has been spurred by the high levels of surplus savings and reserves in Asia and Gulf regions. Asia has a savings rate which is higher than any other region in the world and is expected to remain between 30 and 40 per cent of GDP for many years to come.

The sukuk market brings with it many benefits to both issuers and investors. Issuers can benefit from the huge increase in liquidity in the Islamic world, and can tap on these new sources of funds. Raising funding from the Islamic bond market in the current environment has been 10 to 20 basis points lower than mainstream bonds. An increased number of multilateral agencies are issuing sukuk to finance development projects. In addition, both government agencies and the corporate sector have considered the sukuk market as an attractive source of financing. From the investor perspective, there are the

benefits of diversification. In a sukuk issue in 2005, 48 per cent of the issuance were subscribed by conventional-based investors. This increased appetite for sukuk reinforced by excess liquidity in the global financial system is part of the reasons sukuk are attractively priced for issuers.

### ***Extending the linkages to other parts of the world***

The emergence of Islamic financial products, in particular, in the capital market has also promoted greater global financial integration. The bringing together of financial institutions and market players across continents to participate in this expansion of inter-regional investment flows has fostered financial linkages among the major regions. This will not only provide great synergies and opportunities but will contribute towards facilitating international financial stability.

Just as the old Silk Road in the 14<sup>th</sup> century offered a route that facilitated the spice trade from the East to the West, we can now envisage the new Silk Road which financial flows across borders between the East and West, thereby promoting international financial integration. In this context, the Islamic capital market, in particular, the sukuk market has a major role in strengthening this interlinkage. The essence of the New Silk Road is to provide a route for such flows and promote greater financial integration for the benefit of a wider community. The New Silk Road should not be envisaged as just a link between Asia and the Middle East but that which extend to Europe and the rest of the world. Indeed, we are already seeing the participation of global investors and the international financial community. The participation of a financial centre like London will foster the global growth and international integration of this market. The involvement of regulators and government agencies is also contributing to accelerating this process.

Malaysia is one of the key intermediary destinations along this New Silk Road that

offers a platform for the origination, distribution and trading of Islamic capital market and treasury instruments, including sukuk. Malaysia is positioning itself as an Islamic investment gateway to Asia, with a niche in Islamic fund and wealth management. Malaysia has developed a comprehensive Islamic financial system that operates in parallel with the conventional financial system. Of significance, is the inter-connectivity within the system that includes the banking and takaful industries, and the Islamic money and capital markets - a matrix which mutually reinforces the integrity and stability of the Islamic financial system. This is supported by the financial infrastructure, the legal and regulatory framework and the expertise to contribute to the growth of Islamic finance.

### ***Malaysia's achievements in developing the sukuk market***

Allow me to share the Malaysian experience in developing the sukuk market. The Malaysian Islamic bond market has made significant progress since the first sukuk issue in 1990 by a multinational corporation operating in Malaysia. The development of the market involved initiatives to facilitate an efficient issuance process, the price discovery process, the broadening of the investor base, the establishment of a benchmark yield, the liquidity in the secondary market and the strengthening of the regulatory framework. These initiatives have been reinforced by the legal and Shariah framework and the supporting financial infrastructure including the settlement and bond information system.

Following the development of a robust and vibrant domestic market, initiatives have now been taken to raise the significance of the international dimension of our Islamic financial system. This has included wide ranging liberalization measures including bringing in new Islamic finance foreign players into our system through the issue of new licences and allowing for greater levels of foreign interest in our domestic financial institutions.

The liberalisation has also involved the potential for greater foreign participation in our domestic financial markets.

In 2002, Malaysia achieved a further significant milestone when the Malaysian government issued the first global sovereign sukuk, raising USD600 million. With this issuance, it became an international benchmark for the issuance of global sukuk. The sukuk issue was listed on the Luxembourg Stock Exchange, Labuan International Financial Stock Exchange and Bahrain Stock Exchange. There has since been further sovereign issues in the global capital market.

In 2006, the Malaysian market saw the launch of a sukuk using concepts such as Mudharabah, Musyarakah and Ijarah. The issuers included Malaysia's government-linked companies. A landmark example was the USD750 million exchangeable sukuk Musyarakah by Khazanah, the government's investment corporation for the purpose of selling a stake in Telekom Malaysia. It marked the world's first issue of its kind, incorporating full convertibility features common to conventional equity-linked transactions.

Following these developments, the Malaysian sukuk market has attracted a wide range of lead arrangers. In addition, the rising demand and the growing number of issuers and the broadening investor base has led to the growing sophistication of the market. By January 2007, Malaysia accounted for 67 per cent, about two-thirds of the global sukuk outstanding, amounting to about USD47 billion.

The growth in the sukuk market also reflects the commitment and combined efforts of the Malaysian government and regulators. There is a clear articulation of the vision and policies to drive the local Islamic capital market. This is reinforced by the implementation of a strong legal, regulatory and tax framework.

Bank Negara Malaysia and the Securities Commission have worked closely on a sequence of vital blueprints: the 10-year Financial Sector Master Plan, the 10-year Capital Market Master Plan and the Islamic securities guidelines. The government has reaffirmed all these plans and initiatives with the announcement of a range of tax measures in the 2006 budget.

Another important aspect of the development of the sukuk market is the development of the other key components of the Islamic financial system, the money market, banking, and takaful sectors. The various components are able to meet the different requirements of the economy including the differentiated tenor for which the funds are required. This includes providing stable long-term funds for large investments and development projects. These would allow for a balanced allocation of financial and economic resources within the economy, diversifying the risks through the Islamic financial system, and enhancing its flexibilities to adjust, thus strengthening its resilience.

As Malaysia moves to a more liberalised and globalised Islamic capital market, the role of the industry in advancing the Islamic financial system becomes increasingly important. The role of the industry has been important in spearheading product innovation, branding, profiling, promotion and marketing of the Islamic capital market products and services. This has contributed to the development of a deeper and more liquid, efficient, transparent and effective sukuk market.

### ***Challenges in the development of the Global Islamic capital market***

While much has been achieved, much remain to be done. Let me turn to some of the challenges and initiatives taken to address them. A vital ingredient for the development of capital markets, including the Islamic capital market, is the creation of a secondary trading

platform for the capital market instruments. This will provide investors with the flexibility in managing their liquidity requirements. In this respect, more needs to be done in terms of the creation of a continuous supply of Islamic papers and instruments that would promote the secondary trading of instruments and add greater depth to the market.

There also needs to be greater diversity in the type and maturity of the sukuks in the market for Islamic financial institutions and portfolio managers to manage their funds effectively. As part of the efforts to address these issues, the Malaysian government regularly issues sukuk with different maturities in order to create a benchmark yield curve. Since the year 2000, the government has developed an auction calendar for both the conventional and sukuk government issues. In 2005, the government commenced issuing shorter term Islamic treasury bills and longer-dated sukuk, with a maturity of 10 years, to further diversify the instruments available to investors. In the Malaysian sukuk market, Islamic private debt securities now account for 50 per cent of the total private debt securities market.

Another challenge to the growth of the market concerns pricing issues. For the Islamic security to be efficiently priced and credible, further initiatives need to be undertaken to develop its own indicator. For example, if a sukuk is issued based on the Ijarah principle, and uses the property as its underlying asset, the actual rate of rental may be explored to be used to determine the rate of return on the instrument. It would then fluctuate depending on the demand and supply for that property. It will then give a true reflection of the price of the underlying asset.

Shariah experts, who have a full understanding of the mechanics of sukuk, are key to ensuring its proper governance. And shariah decisions, when made, should be transparent and disclosed. This will allow others to appreciate the juristic reasoning, which in turn should lead to wider acceptance

of shariah decisions, particularly if they have implications on cross-border transactions. In relation to this, a guide for issuers and investors to refer with regards to shariah decisions would facilitate the development of the market.

Of further importance is the attainment of the convergence of Shariah principles and interpretation to ensure market confidence among investors from different parts of the world. To achieve this, there needs to be continuous investments in intellectual capital and greater engagement among Shariah scholars. The regular engagement that is now taking place among the scholars is already producing this convergence.

Similarly for the global acceptance of Islamic finance, the harmonisation of standards and practices is important. Full support has to be accorded to the international standard setting organizations such as Islamic Financial Services Board (IFSB) and to the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) to formulate appropriate standards that would strengthen the Islamic financial system. The IFSB has already formulated the prudential treatment for sukuk investment by the Islamic financial institutions as stipulated in the Capital Adequacy Standards. The IFSB has also undertaken initiatives to

strengthen the framework and practices in the Islamic money market. Further work is being undertaken to formulate strategies for strengthening the liquidity management framework and to identify measures to develop benchmark Islamic securities that can help to determine benchmark rate for system-wide application.

### ***Global co-operation to develop the Islamic financial markets.***

Indeed, while there remains many challenges that need to be overcome, the overall direction and potential of the global Islamic financial markets are certainly well recognised. Greater engagement and interface between the industry, the scholars, and the authorities will create greater awareness, understanding and appreciation of the issues and the direction for its resolution. This will provide an environment in which the full potential of Islamic finance can be realised. This is indeed a global challenge and it will be the cumulative efforts of the scholars, industry and authorities that will produce the best outcome.

In conclusion, I would like to congratulate the organisers in successfully providing a platform at this conference for all the sukuk stakeholders ranging from the issuers to investors. I wish all of you a highly productive and successful conference.

## CALENDAR OF EVENTS May-June 2007

### **14 May 2007**

The Bank organised a Malaysia Country Showcase in Dubai, in conjunction with the 4th Islamic Financial Services Board (IFSB) Summit. The showcase is part of the Malaysia International Islamic Financial Centre (MIFC) initiatives to attract investors, particularly from the Middle East, to invest in Malaysia. The event attracted bankers, fund managers and corporations from the region. In his opening remark, Deputy Governor Dato' Mohd Razif Abd. Kadir said that Malaysia is well positioned to support investment flows between Asia and the Middle East through the provision of Islamic finance services and products.

### **15 May 2007**

At the 4th IFSB Summit, Governor spoke on the need for cross-sectoral approach in the supervision of Islamic financial services, in order to build a viable and sustainable Islamic financial system. She said that efforts to strengthen the international Islamic financial architecture and to enhance international cooperation and collaboration need to continue, to deal with the changing configurations of a highly dynamic and rapidly evolving environment.

### **16 May 2007**

The Bank signed a Commodity Murabahah Agreement with Saudi Hollandi Bank of Saudi Arabia – the first Islamic banking institution outside of Malaysia to do so. The Commodity Murabahah Programme, introduced by the Bank in March 2007, is part of its diverse range of policy instruments to manage short-term liquidity in the Malaysian Islamic interbank money market. Earlier, the Bank had executed master agreements with eight local Islamic banking institutions. The programme is part of the Bank's efforts to spur product innovation in facilitating the liquidity management of Islamic financial institutions. The participation of foreign Islamic financial institutions would further strengthen the cross-border inter-linkages as well as investment flows between Islamic financial centres. The Bank, subsequently, signed a similar agreement with CIMB Bank London on 20 June 2007.

### **28 May 2007**

At its fourth meeting for 2007, the Bank's Monetary Policy Committee (MPC) decided to leave the Overnight Policy Rate (OPR) unchanged at 3.50 percent. In its statement, the MPC highlighted that despite moderate export growth, strong domestic demand has sustained the growth of the Malaysian economy. The inflation rate during the first four months of 2007 averaged 2.4% and continues a downward trend with the rate for the whole year expected to be within the projected range of 2-2.5 percent.

### **30 May 2007**

The Bank announced that the Malaysian economy continued to expand by 5.3% in the first quarter of 2007 (4Q 2006: 5.7%). Domestic demand, driven by the private sector consumption and investment activities, was reinforced by increased public investment spending. On the supply side, growth was supported by strong expansion in the services sector and higher construction activity.

### **18 June 2007**

At the Malaysia–Indonesia Investment & Finance Summit in Jakarta, Indonesia, Governor spoke on the need to enhance financial integration in the South East Asian region – the New Nusantara region – comprising Indonesia, Malaysia, the Philippines, Singapore and Thailand. Enhanced financial integration will serve as a powerful catalyst for future expansion of intra-regional trade and investment that will lead to self-sustaining and mutually reinforcing economic growth in the region. Governor also highlighted that greater cooperation between the region’s monetary and regulatory authorities will promote better resilience and reduce regional vulnerability to external developments.

### **20 June 2007**

At the Sukuk Summit 2007 in London, Governor delivered a keynote address which highlighted Malaysia’s achievements in developing the sukuk market and the challenges faced in the development of the Global Islamic capital market. She also spoke on the immense role the sukuk market can play in economic development, as well as the role of Islamic finance in extending the economic and financial linkages to other parts of the world. More importantly, Governor called for global co-operation among the international financial communities to develop the Islamic financial markets.

### **26 June 2007**

The Bank announced the introduction of a tiered pricing structure for credit card users to promote the use of credit cards as a payment instrument. This is part of the Bank’s continuous efforts to promote prudent financial management and inculcate good financial discipline among credit card users in Malaysia. Under this new scheme, users who have good repayment records will enjoy reduced finance charges of not more than 15% per annum, from the current maximum ceiling rate of 18% per annum. Card issuers will begin to track the repayment behaviour from 1 July 2007 and the tiered pricing structure will be implemented by 1 July 2008.