

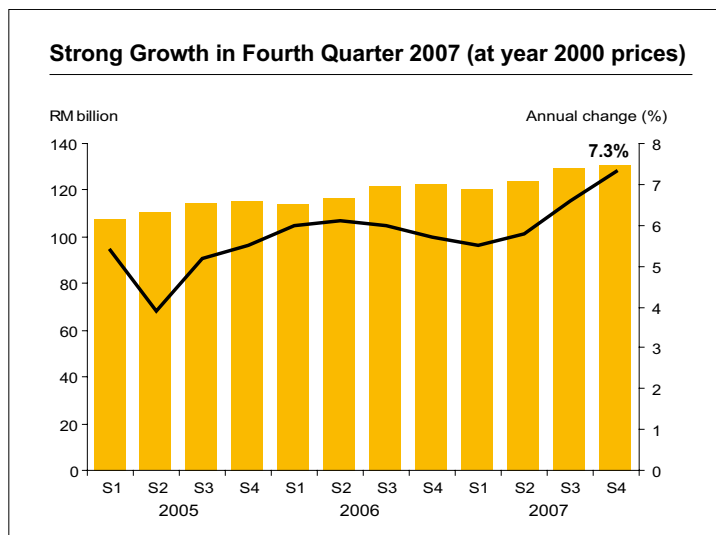
ECONOMIC AND FINANCIAL DEVELOPMENTS IN MALAYSIA IN THE FOURTH QUARTER OF 2007

OVERVIEW

Strong GDP growth in the fourth quarter

The Malaysian economy registered a strong growth in the fourth quarter of 2007. Robust domestic demand, driven by strong private consumption spending and investment activities, raised real GDP growth to 7.3%. This was reinforced by increased in public sector spending. On the supply side, growth was broad based with strong growth recorded in all economic sectors. For the whole year, real GDP expanded by 6.3%.

accommodation and restaurant; as well as finance, insurance, real estate and business services sub-sectors continued to register double-digit growth. Growth in the construction sector was sustained at 4.7% in the fourth quarter supported by activities in the civil engineering and non-residential sub-sectors.



Agriculture and mining sectors recorded robust performance during the fourth quarter. Output in the agriculture sector increased by 6.9% (3Q: 0.7%) following the expansion in crude palm oil output due to recovery in yields. This was supported by higher output of livestock. In the mining sector, the increase in crude oil output of 7.2% was mainly driven by the increased production in the Kikeh deepwater oil field. The production of natural gas, however, continued to decline due to lower external demand.

The manufacturing sector expanded by 5.6% (3Q: 3.3%), reflecting strong expansion in the domestic-oriented industries. Production of domestic-oriented industries grew by 11.1% (3Q: 4.6%) underpinned by the strong performance in transport equipment, food and beverages, and construction related industries. Similarly, production of export-oriented industries performed better during the quarter, supported by an improvement in the electronics and electrical (E&E) sector, particularly computers and parts.

Domestic demand remained strong in the fourth quarter expanding by 9.8% (3Q: 12.6%), on the strength of private sector activities, while the increased public sector spending continued to support growth. Private consumption expenditure grew by 11.1% supported by high disposable income due to strong commodity prices, salary increment in the public sector and stable employment market. The nationwide year-end sales had also encouraged consumer spending. Gross fixed capital formation continued to increase by 11% (3Q: 13.5%). Private investment indicators, namely loans approved and disbursed to the manufacturing and construction sectors as well as imports of capital goods indicated increased in capital spending by the private sector. Similarly,

The services sector continued to be the main impetus to GDP growth, expanding by 9.1%. The wholesale and retail trade,

higher disbursement for development expenditure by the Federal Government was channelled towards agriculture and rural economic activities, improving public utilities and transportation infrastructure as well as for the provisions of education and health services.

The headline inflation rate, as measured by the change in the Consumer Price Index (CPI) increased to 2.2% in the final quarter of 2007 (3Q: 1.8%), due mainly to higher prices in the food and non-alcoholic beverages category and to a lesser extent, in the restaurants and hotels, and miscellaneous goods and services categories.

On the external front, the trade account recorded a surplus of RM28.6 billion in the fourth quarter (3Q: RM28.3 billion). Gross exports strengthened by 7.5% (3Q: 0.9%), due mainly to higher commodity exports and a turnaround in manufacturing exports. Agriculture exports continued on an upward trend, driven mainly by higher prices, especially palm oil prices, following rising global demand amidst lower supply of soybean oil and rapeseed oil in the United States and Europe, respectively. Mineral exports also expanded further during the quarter, led by higher proceeds from crude oil and liquefied natural gas exports. In addition, manufacturing exports registered a positive growth of 2.9% (3Q: -2%), driven mainly by strong growth in selected resourced-based industries as well as a pick-up in E&E exports, especially computer and parts.

Gross import growth was stronger at 10.7% (3Q: 2%) with all import categories registering higher growth. Imports of capital goods (excluding lumpy items) increased by 10%, spurred by strong activity in construction and mining sectors. Capacity expansion and upgrading in the manufacturing sector led to the higher imports of machinery. Imports of intermediate goods also registered a strong growth of 13.3%, reflecting imports of inputs particularly to the E&E sector and resource-

based industries. Imports of consumption goods increased by 3.6% supported by higher imports of food and beverages, and consumer goods.

In the financial account, net inflow of foreign direct investment (FDI), as captured by Bank Negara Malaysia's Cash BOP System (not including retained earnings and investment in the form of imported machinery and equipment) amounted to RM3.3 billion in the fourth quarter (3Q: RM6.8 billion). The bulk of the FDI was channelled into the services, manufacturing, and oil and gas sectors. Overseas investment recorded a net outflow of RM5.1 billion (3Q: -RM7.1 billion). Meanwhile, portfolio investment recorded a net inflow of RM6 billion (3Q: -RM21.9 billion) and largely for net purchases of debt securities by foreign investors which more than offset outflows due to purchases of equity securities abroad by residents.

The international reserves of Bank Negara Malaysia amounted to RM335.7 billion (equivalent to USD101.3 billion) as at 31 December 2007. The reserves increased to RM366.8 billion (equivalent to USD110.9 billion) as at 15 February 2008. The reserves position is sufficient to finance 9.2 months of retained imports and is 6.5 times the short-term external debt.

Monetary policy remained supportive of economic activity

The Overnight Policy Rate (OPR) remained at 3.50% throughout the fourth quarter of 2007, consistent with the medium term outlook of relative price stability and sustainable economic growth.

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

Financing to the private sector continued to increase in the fourth quarter. On a net basis, banking system loans and private debt securities (PDS) outstanding expanded at a combined annual rate of 8.3% at the end of the fourth quarter. Banking system loans outstanding increased at an annual growth rate of 8.6% at the end of the fourth quarter, with loans outstanding to businesses and households expanding at annual growth rates of 10.4% and 7.3% respectively. Loan applications, approvals and disbursements remained high across the business and household sectors.

M3, or broad money, increased at an annual rate of 9.5% at the end of the fourth quarter. The increase reflected net trade and portfolio inflows during the quarter, and increased Government spending.

In the fourth quarter, gross funds raised were higher at RM46.6 billion. However, after adjusting for large redemptions, net funds raised amounted to RM567 million. The public sector recorded a net redemption of RM5.9 billion, while net funds raised through the PDS market, excluding Cagamas, amounted to RM3.9 billion. Funds raised through the equity market amounted to RM3.8 billion.

The ringgit strengthened against the US dollar during the quarter supported by trade-related inflows and renewed portfolio inflows. For the quarter as a whole, the ringgit exhibited a mixed performance against major currencies and appreciated against most regional currencies. The appreciation of the ringgit has continued into early 2008. Although the downturn in global equity markets and concerns about the impact of a slowdown in US economic growth on the region caused the ringgit to temporarily weaken against the US dollar in mid-January, it subsequently reversed following the 75 basis point cut in the Fed Funds rate by the US Federal Reserve on 22 January, and another 50 basis point cut on 30 January 2008. For the period 1 January to 26 February 2008, the ringgit appreciated

against the US dollar and the euro by 2.9% and 2.3% respectively, but depreciated against the Japanese yen by 0.8%. The ringgit strengthened against most regional currencies, except the Thai baht and the Indonesian rupiah against which the ringgit depreciated by 1.5% and 0.4% respectively.

Banking system continued to exhibit high resilience

The banking sector continued to demonstrate high resilience in the fourth quarter of 2007, supported by strong capitalisation and profitability. The capitalisation of the banking system remained strong with risk-weighted capital ratio (RWCR) and core capital ratio (CCR) of 13% and 9.9% respectively as at end of the final quarter of 2007. The banking system also registered a strong growth of 21% in unaudited pre-tax profit to RM5.2 billion (3Q: RM4.3 billion). The non-performing loans (NPLs) level of the banking system continued to improve, with the total net NPLs based on the 3-month classification declining further by 7.4% to RM20.1 billion (3Q: RM21.7 billion) as at end of the fourth quarter, to account for 3.2% of net total loans (3Q: 3.5%). This was attributed mainly to the sale of NPL and higher reclassifications of NPLs to performing status as well as continued write-offs by banking institutions. The strong balance sheets of banking institutions have positioned the banking system to strongly continue to support future economic activities.

Growth to remain on a steady path in 2008

While global growth is expected to moderate, the continued strength of domestic demand in the emerging economies, particularly in the Asian region, are expected to lend some support to global growth. Commodity producing countries will in particular, continue to benefit from high commodity prices. The growth prospect for Malaysia remains favourable. Expanding domestic demand

will continue to provide strong support for the economy. Consumption activities are expected to remain resilient in view of firm labour market conditions and high commodity prices. Underlying private business and investment activities continue to expand,

together with the implementation of projects under the Ninth Malaysia Plan. Near-term indicators as well as the latest six-month smoothed growth rate of the DOSM leading index indicate that the Malaysian economy would remain resilient in 2008.

DEVELOPMENTS IN THE FOURTH QUARTER OF 2007

INTERNATIONAL ECONOMIC ENVIRONMENT

Moderation in economic growth in some major industrial economies while Asian economies maintained their growth momentum

Global growth performance in the fourth quarter of 2007 was mixed, with most industrial economies experiencing a moderation in economic activities while Asian regional economies maintained their growth momentum.

In the **United States (US)**, fourth quarter advance estimates showed that growth weakened to 0.6% (3Q: 4.9%) following further declines in housing investment and lower contribution of net exports to GDP. Growth was, however, still supported by a modest expansion of 2% (3Q: 2.8%) in consumer spending.

Meanwhile in **Japan**, GDP grew at a stronger pace in the fourth quarter at 3.7% (3Q: 1.3%), supported by private consumption, investment and exports. Positive growth was recorded in retail sales and household spending. Exports were sustained due mainly to demand from non-US economies. Investment activity rebounded on stronger capital spending. On the inflation front, prices rose during the quarter for the first time in the year, reversing three quarters of declines, attributed to price increases in energy-related products.

Economic activity in the **euro area** moderated in the fourth quarter to 2.3% (3Q: 2.7%) but remained above its potential level. Fourth quarter growth was limited by weaker growth in Germany, France and Italy. Germany registered a sharp slowdown in the fourth quarter (4Q: 1.8%; 3Q: 2.4%) as gains from investment and net exports were offset by falling consumption activity. Growth in France was also constrained by a reduction in exports and weaker consumer spending.

Meanwhile in the **UK**, growth softened to 2.9% due to slower expansion in the business services and finance sector. Industrial output was also weaker, with a flat growth in the manufacturing sector.

Industrial countries: Real GDP Growth

	2006		2007			Key contributing factors for 4Q growth
	4Q	Year	3Q	4Q	Year	
	Annual change (%)					
US ¹	2.1	2.9	4.9	0.6 ^a	2.2 ^a	Moderate expansion in consumer spending while residential investments declined further.
UK	3.3	2.9	3.3	2.9	3.1	Slower expansion in the business services and financial sector.
Euro zone	3.2	2.9	2.7	2.3 ^p	2.7 ^p	Slower growth in Germany, France and Italy. Significant drop in consumer spending in Germany and France.
Japan ¹	4.2 ^r	2.4	1.3 ^r	3.7 ^p	2.1	Supported by domestic demand, mainly due to growth in investment activity, and healthy export performance.

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

Source: National authorities

In the **US**, the **Federal Open Market Committee (FOMC)** cut interest rates in response to concerns of a sharper US slowdown. In the fourth quarter of 2007, the FOMC cut interest rates by a total of 50 basis points. At the beginning of 2008, the FOMC reduced interest rates by another 125 basis points, including an inter-meeting rate cut of 75 basis points that was the largest unscheduled cut on record. The monetary policy stance was biased towards reducing the heightened risks of a sharp economic slowdown due to the tightening credit conditions for households and businesses as well as the stresses in the financial system and markets.

Meanwhile, in other industrial countries, inflationary pressures remained a concern despite growing risks to growth. The **European Central Bank** maintained policy rates during the fourth quarter of 2007. However, amidst growing pressures from a slowing economy and a weakening financial sector, the **Bank of England** cut interest rates by 25 basis points in the fourth quarter of 2007 and again by 25 basis points at its February 2008 meeting. Meanwhile, the **Bank of Japan** maintained interest rates at 0.5% despite the gradual rise in consumer prices as weaker external demand conditions raised the risks to economic growth.

Global **crude oil prices** rose to new highs in the fourth quarter of 2007 amidst concerns over supplies during the winter season and the weakness in the US dollar. For 2007 as a whole, crude oil prices increased by 9.2% and averaged USD72.32 per barrel (2006

average: USD66.23) and reached a new intraday record high of USD100.09 per barrel on 3 January 2008.

Economic activity in the **Asian region** remained robust in the fourth quarter, led by People's Republic of China (PR China) with robust growth of 11.2%. The growth momentum in the region was supported mainly by rising domestic demand amidst weaker external demand conditions arising from a slowing US economy. While inflation remained a concern for most regional economies, most regional central banks kept policy rates on hold while a few eased rates to address country-specific issues.

In the **foreign exchange market**, the US dollar ended the quarter weaker against most major currencies. Dollar performance was mainly affected by prospects of a sharper US slowdown and expectations for further interest rate cuts by the Fed. The US dollar continued to reach multi-year lows against the Japanese yen due to the unwinding of yen carry trades. Regional currencies also appreciated in the quarter against the US dollar due to continued strong trade and portfolio inflows.

Going forward, global growth is expected to moderate, reflecting a slowdown in the major industrial economies and continued uncertainties in global financial markets. Notwithstanding the less favourable global economic conditions, regional growth remains supported by the continued strength in domestic demand while high commodity prices will continue to provide added impetus to commodity producing countries in the region.

Regional Countries: Real GDP Growth

	2006		2007			Key contributing factors for 4Q growth
	4Q	Year	3Q	4Q	Year	
	Annual change (%)					
P.R. China	10.4	11.1	11.5	11.2	11.4	Growth remains supported by robust domestic demand amidst some moderation in external demand.
Singapore	6.6	8.2	8.9	5.4	7.7	Positive performance in the construction and services sector continued to sustain growth.
Philippines	5.5	5.4	7.4	7.4	7.3	Driven by strong consumer spending.
Indonesia	6.1	5.5	6.5	6.2	6.3	Due to strong domestic demand and commodity exports.
Chinese Taipei	4.0	4.9	6.9	6.4	5.7	Growth was supported by robust performance in exports.
Korea	4.0	5.0	5.2	5.5	4.9	Growth was supported by robust performance in the manufacturing sector.
Thailand	4.2	5.1	4.9	5.7	4.8	Growth was supported by robust performance in exports and domestic demand.

Source: National authorities

DEVELOPMENTS IN THE MALAYSIAN ECONOMY

The economy continued on a steady growth path

Real GDP expanded by 7.3% in the fourth quarter of 2007 (3Q: 6.6%), with all economic sectors recording strong growth. The

the domestic-oriented industries in line with the sustained domestic demand conditions, and aided by the improvement in the E&E sub-sector.

Production of **export-oriented industries** recorded a higher growth due mainly to the improvement in the E&E sub-sector (5.9%; 3Q: 2.1%). The growth in the E&E industry was attributable to the strong performance in the computers and parts segment (16.4%; 3Q: -0.1%) in tandem with improved demand from the US. Resource-based industries, especially off-estate processing and petroleum products, also performed better during the quarter in line with the expansion in the upstream activities. However, growth in the chemicals and chemical products industry was subdued due mainly to the contraction in the production of industrial gas.

Quarterly GDP by Kind of Economic Activity at Year 2000 Prices¹

	2006		2007		
	4Q	Year	3Q	4Q	Year
	Annual change in (%)				
Agriculture	5.1	5.2	0.7	6.9	2.2
Mining	2.1	-0.4	2.3	3.5	3.2
Manufacturing	4.0	7.1	3.3	5.6	3.1
Construction	0.6	-0.5	4.7	4.7	4.6
Services	8.0	7.2	10.5	9.1	9.7
Real GDP (Ann. Chg.)	5.7	5.9	6.6	7.3	6.3
Real GDP (Preceding Chg.)	0.5	5.9	4.8	1.2	6.3

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

Source: Department of Statistics, Malaysia

manufacturing sector, recorded a stronger growth, with firm expansion in the domestic-oriented industries and improvement in the E&E sub-sector. Sustained domestic demand and robust business activity supported growth in the services sector. The commodities sector also showed an improved performance. Higher growth in the agriculture sector was led by the yield upcycle in crude palm oil production, while mining activity was supported by expansion in crude oil production at the new Kikeh oil field. Meanwhile, growth the construction sector was sustained, supported by implementation of projects under the Ninth Malaysia Plan.

Manufacturing sector led by domestic-oriented industries

Value-added growth in the **manufacturing sector** increased by 5.6% in the fourth quarter of 2007 (3Q: 3.3%). The growth was supported by strong expansion in

Performance in the Manufacturing Sector

	2006		2007		
	4Q	Year	3Q	4Q	Year
	Annual change (%)				
Value Added (Constant Price)	4.0	7.1	3.3	5.6	3.1
Overall Production	5.3	7.5	1.9	4.9	1.9
Export-oriented industries	4.3	7.5	1.3	3.5	0.7
<i>Of which:</i>					
Electronics and electrical	1.9	7.9	2.1	5.9	-0.9
Electronics	4.5	11.8	3.9	10.4	1.5
Electrical	-5.5	-2.9	-3.9	-8.6	-8.5
Chemicals and chemical products	-0.6	3.2	0.3	-1.5	1.7
Petroleum products ¹	12.8	13.6	1.9	3.6	5.4
Textiles, wearing apparel & footwear	1.5	6.1	-5.9	-11.3	-9.7
Wood and wood products ²	9.7	3.8	0.1	-0.4	1.3
Rubber products	15.2	7.2	3.4	0.5	5.6
Off-estate processing	9.6	5.7	-0.3	12.2	-0.5
Domestic-oriented industries	9.9	7.2	4.6	11.1	6.8
<i>Of which:</i>					
Non-metallic mineral products	9.2	3.3	0.0	1.1	0.5
Iron & steel and non-ferrous metal	20.5	3.0	13.6	15.2	14.8
Food	9.7	6.7	0.1	6.7	7.2
Transport equipment	-14.0	-1.5	-0.6	17.6	-5.5
Fabricated metal products	30.1	26.5	15.0	18.5	19.2
Total Manufactured Exports	5.7	10.1	-2.0	2.9	0.3
<i>Of which:</i>					
Electronics and electrical products	1.7	6.4	-5.6	-2.2	-4.2
Chemicals and chemical products	17.6	10.7	3.2	8.8	13.7
Petroleum products	2.5	27.2	-5.7	42.7	3.6
Wood and wood products	26.8	16.7	-17.4	-23.7	-6.3
Furniture & parts	7.6	7.9	1.0	1.5	5.9
Rubber products	30.8	34.3	1.3	19.5	13.2

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

² Output of furniture and parts are not captured in the wood production data

Source: Department of Statistics, Malaysia

Output of **domestic-oriented industries** strengthened during the quarter underpinned by the better performance in the transport equipment industry as well as stronger growth in the food and beverage industries. The transport equipment industry turned around (17.6%; 3Q: -0.6%) in tandem with the stronger sales of new motor vehicles (19%; 3Q: 4.9%). Growth was also supported by the substantial increase in the production of parts and accessories for motor vehicles and engines (27.6%; 3Q: 3.9%). The growth momentum in the construction sector benefited the related building materials

industries such as iron and steel, and fabricated metal products. However, the performance of the non-metallic mineral products was affected by the slowdown in production of glass due to the shrinking cathode ray tube television market.

For the quarter as a whole, the manufacturing sector was operating at the capacity utilisation rate of 77%, with both export- and domestic-oriented industries averaging at 79% and 70% respectively.

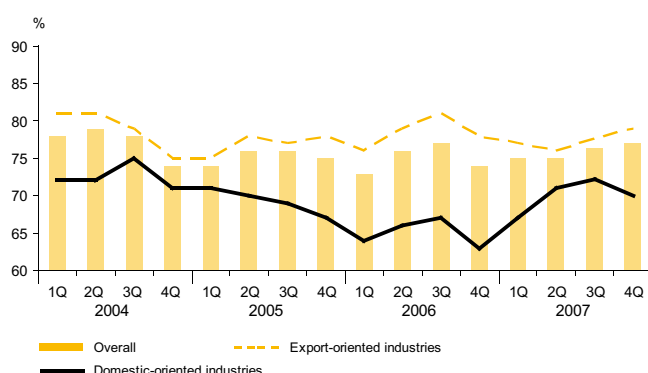
Sustained strong growth in the services sector

The services sector recorded a strong growth of 9.1% in the fourth quarter supported by both intermediate and final services. The finance, insurance, real estate and business services; and wholesale and retail trade, accommodation and restaurants sub-sectors remained the key drivers of growth, expanding at double-digit pace.

The **finance, insurance, real estate and business services** sub-sector benefited from increased lending activities and growth in fee-based income and business activity arising from the favourable performance in the equity market. During the quarter, the insurance segment also saw an improved performance, particularly the life insurance segment. Growth continued to emanate from new growth areas, namely IT services, shared services and outsourcing (SSO) and professional and consultancy services. Twelve new SSO companies were granted approval during the quarter (3Q: 5 companies) in the Multimedia Super Corridor.

Growth in the **wholesale and retail trade, accommodation and restaurant** sub-sector was driven by higher domestic consumption

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

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

	Share 2006	2006		2007		
		4Q	Year	3Q	4Q	Year
	%	Annual change in (%)				
Intermediate Services	42.8	9.5	7.6	12.6	10.1	12.0
Transport, storage & communication	14.2	6.8	6.0	10.1	9.9	8.5
Transport & storage	7.0	6.7	5.2	13.1	12.7	10.2
Communication	7.2	6.8	6.8	7.1	7.1	6.9
Finance, insurance, real estate & business services	28.6	10.8	8.4	13.9	10.2	13.7
Finance & insurance	19.8	8.8	7.7	8.8	9.8	10.7
Real estate & business services	8.8	15.6	9.9	25.1	11.0	20.6
Final Services	57.2	7.0	7.0	8.9	8.4	7.9
Electricity, gas & water	5.9	6.2	5.2	2.9	4.4	4.0
Wholesale & retail trade, accommodation & restaurant	26.6	6.4	6.9	14.5	12.5	12.0
Wholesale & retail trade	22.3	6.0	7.1	14.9	12.5	12.2
Accommodation & restaurant	4.2	9.1	6.0	12.4	12.3	10.9
Government services	13.6	10.6	9.8	3.8	4.2	4.2
Other services	11.1	4.5	4.7	4.9	5.4	5.0
Total Services	100.0	8.0	7.2	10.5	9.1	9.7

Source: Department of Statistics, Malaysia

and tourism activities as reflected by increase in tourist arrivals, imports of consumption goods and credit card spending. High tourist arrivals was in response to the Visit Malaysia Year 2007 activities, while high commodity prices and salary increment in the public sector supported higher spending amongst domestic consumers. During the quarter, the automotive trade sector picked up after a long period of subdued performance due to pent-up replacement demand as well as demand from first-time car owners following the introduction of new models.

Meanwhile, the **transport, storage and communication** sub-sector continued to perform favourably led mainly by the transportation segment owing to increased activity in the air and sea transportation segments. Expansion in the telecommunication industry reflected the strong performance in both data and voice usage as well as increased cellular subscriber base. The **utilities** sub-sector recorded a higher growth attributable to increased demand for electricity from households as well as sustained demand from the industrial and commercial sub-sectors.

Stronger performance in commodities

Output growth in both agriculture and mining sectors was stronger during the quarter. The agriculture sector expanded by 6.9% amidst a strong rebound in the production of crude palm oil, while the mining sector rose by 3.5% due to substantially higher output of crude oil.

In the **agriculture sector**, production of crude palm oil turned around to expand by 12.9%, the first quarter of positive growth after three successive quarters of contraction. The recovery was driven by a substantial rise in yields of fresh fruit bunches of 8.9% in the quarter to an average of 5.48 tonnes per hectare (4Q 2006: 5.03 tonnes per hectares). Growth in the agriculture sector was also contributed by higher output of livestock,

Selected Quarterly Indicators in the Services Sector

	2006		2007		
	4Q	1Q	2Q	3Q	4Q
	Percentage at end-period (%)				
Cellular phone penetration rate	72.3	77.0	78.2	80.8	85.1
Internet subscribers penetration rate	14.0	14.0	14.2	14.3	14.3
Broadband subscribers penetration rate	3.3	3.7	4.1	4.5	5.0
	Index				
MIER Consumer Sentiment Index	110.9	124.1	115.9	117.5	110.7
MIER Retail Trade Index	99.2	118.8	129.5	145.9	141.2
MIER Tourism Market Index	127.2	133.8	131.6	131.1	133.6
	Annual change (%)				
Total consumption credit outstanding	14.9	12.8	7.1	6.9	7.0
Loans outstanding to the wholesale & retail trade, hotels & restaurants	12.0	10.1	-0.2	6.1	7.1
Imports of consumption goods	12.1	8.9	1.1	1.2	3.6
Total sales of motor vehicles	-24.7	-15.3	-9.1	4.9	19.0
Container cargo handled (Port Klang and PTP)	18.7	18.5	12.2	9.7	14.4

Source: Various sources

Performance in the Agriculture Sector

	2006		2007		
	4Q	Year	3Q	4Q	Year
	Annual change (%)				
Value Added (at year 2000 prices)	5.1	5.2	0.7	6.9	2.2
Industrial Crops	4.3	4.1	-1.9	7.8	0.4
Food Crops	6.3	6.8	4.7	5.5	4.9
Production¹					
<i>Of which:</i>					
Crude palm oil	10.7	6.1	-0.1	12.9	-0.4
Crude palm kernel oil	14.7	6.1	-6.7	8.9	-2.5
Rubber	12.1	14.0	-11.0	-7.1	-6.4
Cocoa	-19.9	14.2	21.8	29.9	10.2
Fish	5.6	11.4	-2.6	4.9	0.2
Livestock	14.0	18.0	2.7	6.5	9.9
Exports (RM million)	22.1	12.5	29.9	40.2	25.0
<i>Of which:</i>					
Palm oil ('000 tonnes)	20.9	7.2	-3.0	5.6	-3.5
(RM/tonne)	14.7	6.0	63.0	57.4	53.4
(RM million)	38.6	13.7	58.2	66.2	48.1
Palm kernel oil ('000 tonnes)	15.4	-10.1	-4.4	26.7	17.7
(RM/tonne)	-9.9	-16.1	56.8	78.9	42.0
(RM million)	3.9	-24.6	49.9	126.7	67.1
Rubber ('000 tonnes)	1.4	1.3	-1.8	-9.7	-10.9
(Sen/kilogramme)	11.1	40.5	-12.5	14.0	0.0
(RM million)	12.7	42.3	-14.0	2.9	-10.9
Sawn timber ('000 cu.metres)	5.2	-9.9	-7.0	-26.5	-10.8
(RM/cu.metre)	4.1	18.8	3.4	-0.5	4.3
(RM million)	9.5	7.0	-3.8	-26.9	-6.9
Saw logs ('000 cu.metres)	-3.2	-17.1	13.0	-12.0	-2.7
(RM/cu.metre)	7.2	10.7	-4.5	-7.6	-4.0
(RM million)	3.8	-8.3	8.0	-18.7	-6.6
Cocoa beans ('000 tonnes)	-8.2	45.8	15.7	156.6	31.9
(RM/tonne)	10.1	3.7	29.7	19.1	16.0
(RM million)	1.1	51.2	50.0	205.6	53.0

¹ In '000 tonnes, except for saw logs in '000 cubic metres and livestock in numbers slaughtered (Peninsular Malaysia only)

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

particularly poultry, in response to strong domestic demand amidst the festive season during the quarter. Meanwhile, rubber output declined further (-7.1%, 3Q: -11%) as tapping activities were disrupted by prolonged rainy conditions in the northern states of Peninsular Malaysia.

In the **mining sector**, output of crude oil (including condensates) expanded strongly by 7.2% to 728,578 barrels per day (bpd). The higher growth was driven entirely by the substantial rise in crude oil output in Sabah to 123,962 bpd (4Q 2006: 79,544 bpd), on rising production capacity in the Kikeh oil field, which came into operation in August 2007. Meanwhile, natural gas production declined by 2.2% amidst the weaker external demand for LNG.

Continued momentum in the construction sector

Growth in the **construction sector** was sustained at 4.7% in the fourth quarter (3Q: 4.7%), reflecting strong activity in the **civil engineering** sub-sector amidst the implementation of projects under the Ninth Malaysia Plan. Growth was further supported by the **non-residential** segment, due to increased construction of purpose-built office space, particularly in the Klang Valley. The **residential** segment also recorded positive growth during the quarter.

Domestic demand remained strong

Domestic demand remained strong, expanding by 9.8% in the fourth quarter, driven mainly by private sector activities. The public sector remains supportive of growth whilst the fiscal consolidation programme is sustained.

Performance in the Mining Sector

	2006		2007		
	4Q	Year	3Q	4Q	Year
	Annual change (%)				
Value Added (at year 2000 prices)	2.1	-0.4	2.3	3.5	3.2
Production					
<i>Of which:</i>					
Crude oil and condensates ('000 barrels)	-6.5	-5.2	4.4	7.2	4.3
Natural gas (net) (million standard cubic feet)	4.4	-0.4	-0.8	-2.2	1.4
Exports (RM million)	0.5	8.6	6.6	23.6	8.1
<i>Of which:</i>					
Crude oil and condensates ('000 tonnes) (USD/barrel)	-8.1	-8.0	-2.0	3.8	0.6
(RM million)	4.2	21.3	4.6	37.7	10.1
Liquefied natural gas ('000 tonnes) (RM/tonnes)	-8.0	8.1	-3.2	32.4	3.5
(RM million)	1.8	-1.9	1.6	-3.7	5.3
	8.7	14.2	10.0	12.5	6.7
	10.7	12.0	11.8	8.3	12.3

Source: PETRONAS
Department of Statistics, Malaysia

Construction Indicators

	2006		2007		
	4Q	Year	3Q	4Q	Year
	Annual change (%)				
New sales and advertising permits	-2.7	-17.6	10.6	-3.1	2.0
Housing approvals	-20.0	-23.2	-4.7	-6.0	-11.5
Production of construction-related materials	12.8	3.2	4.4	5.9	5.2
Loans approved for construction	73.2	12.9	38.8	27.7	55.9
Imports of construction materials and mineral products	-8.2	7.8	-2.0	58.2 ¹	13.8 ²

¹ October-November 2007

² January-November 2007

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

Private consumption activities continued with buoyant double-digit growth (11.1%) for the third consecutive quarter. Strong consumer spending was supported by higher disposable income due to strong commodity prices, the salary increment for civil servants and stable employment market. Almost all major consumption indicators showed an upward trend. In particular, credit card spending, sales of passenger cars, and loans approved and disbursed to household recorded robust double-digit growth during the quarter. The nationwide year-end sales also provided a further boost to consumer spending. Although the Malaysian Institute of Economic Research (MIER)'s Consumer

Sentiments Index was lower in the fourth quarter, it was still above the 100-point threshold, suggesting households' optimism on income expectations and employment prospects. This was further supported by the strong performance of the domestic equity market.

Public consumption grew by 4.4%, as expenditure on emoluments and supplies and services remained high in the quarter.

Meanwhile, **gross fixed capital formation** registered a growth of 11% (3Q: 13.5%). Major investment indicators such as loans approved to manufacturing and construction sectors as well as imports of capital goods grew strongly, indicative of sustained growth in investment activities. High capacity utilisation rates in the manufacturing sector and positive business sentiments as reflected in the MIER's Business Conditions Index which remained above the 100-point benchmark, provided added support to the rise in investment spending. Public sector investment was also higher, as the Federal Government stepped up the disbursement of development expenditure. The bulk of the spending was mainly channelled towards agriculture and rural development, improving public utilities and transport infrastructure as well as for provision of education and health services.

Inflation averaged 2.2%

The average CPI inflation in the final quarter of 2007 increased to 2.2% (3Q: 1.8%) mainly on account of higher prices in the food and non-alcoholic beverages category and to a lesser extent, in the restaurants and hotels, and miscellaneous goods and services

GDP by Expenditure Components (at constant 2000 prices)

	2006		2007		Year
	4Q	Year	3Q	4Q	
Annual change (%)					
Aggregate Domestic Demand (excluding stocks)	7.1	7.0	12.6	9.8	10.5
Consumption	6.2	6.6	12.2	9.4	10.6
<i>Private sector</i>	7.0	7.1	14.0	11.1	11.7
<i>Public sector</i>	4.1	5.0	5.3	4.4	6.4
Gross Fixed Capital Formation	9.8	7.9	13.5	11.0	10.2
Exports of Goods and Services	5.2	7.4	2.5	7.4	3.7
Imports of Goods and Services	5.0	8.6	1.9	9.6	4.1
GDP	5.7	5.9	6.6	7.3	6.3

Source: Department of Statistics, Malaysia

Consumer Sentiment and Business Confidence was Sustained



categories. Food prices rose by 3.7% (3Q: 2.7%), given higher prices for rice, bread and other cereals; meat; fish and seafood; milk, cheese and eggs; and food consumed away from home. The impact on overall inflation was, however, partly mitigated by the lower inflation in the alcoholic beverages and tobacco category following the lapse of the impact of higher excise taxes on alcoholic beverages and tobacco announced in Budget 2007. The clothing and footwear and communication categories also continued to exhibit declining prices.

Producer price inflation rose in the fourth quarter to 10% (3Q: 5.8%), driven mainly by higher prices in the commodity-related sectors, as international prices for commodities rose during the quarter. In addition, prices in the non-commodity-related sectors increased by 4.1% (3Q: 3.7%), as higher prices were recorded in the machinery and transport equipment; and chemical and related products categories.

Labour market conditions remained strong

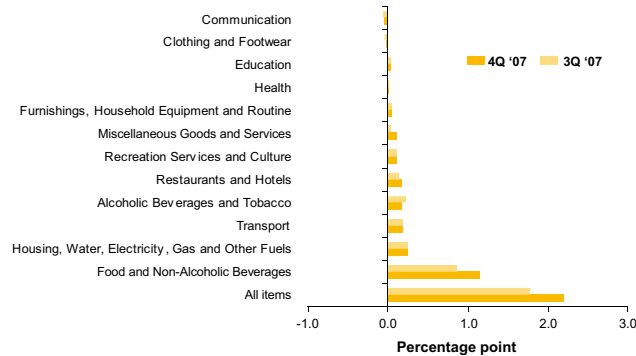
Labour market conditions

in the fourth quarter of 2007 remained favourable. Demand for workers remained strong, with total vacancies remaining high, and outpacing retrenchments. In addition, labour productivity in the manufacturing sector recovered to record a positive growth of 0.4%, after four successive quarters of negative growth. Although the MIER Employment Index moderated in the fourth quarter, it remained well above the 100-point threshold, suggesting continued optimism in income expectations and employment prospects.

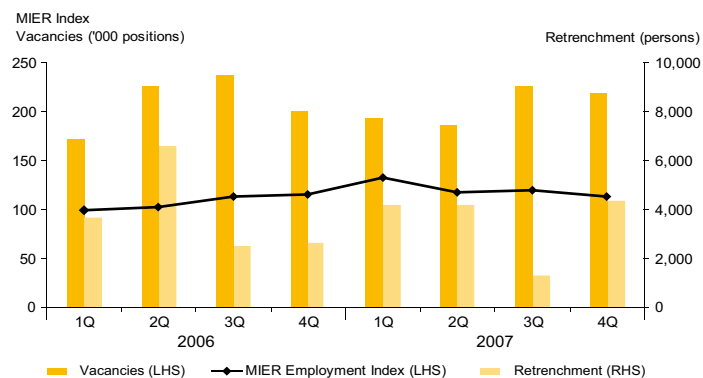
Total vacancies reported via the Electronic Labour Exchange (ELX) remained high at 219,179 positions (3Q: 226,036 positions), with significant levels of job openings reported in the manufacturing (34%), agriculture (30%) and services (24%) sectors. Vacancies advertised in the ELX were available for elementary occupations (53%) such as labourers and general workers in the manufacturing, agriculture, construction and services sectors, as well as for jobs requiring mid- to high-level skills (47%) such as managers, clerical workers, sales and service workers.

A total number of 4,345 persons were retrenched in the fourth quarter (3Q: 1,308

Contribution to Inflation



Labour Market Conditions



persons), due mainly to the manufacturing sector, in particular the E&E industries (43% of total retrenchment). The services sector accounted for another 28% of retrenchments, emanating from the distributive trade, hotels, restaurants, real estate and business services segments (17% of total retrenchment). Retrenchments during the quarter continue to affect mainly the mid- to lower-skilled workers, such as the production workers as well as sales and services workers.

Labour productivity in the manufacturing sector, as measured by real sales value per employee, increased by 0.4% in fourth quarter (3Q: -2.5%), on stronger sales growth. Labour productivity growth in the export-oriented industries remained weak but recorded a smaller contraction (-1.3%; 3Q: -4.7%) mainly due to better performance in the petroleum industry. Nevertheless, labour productivity in the

domestic-oriented industries increased further (9.2%; 3Q: 8.2%), driven by healthy sales growth (17.9%), in particular for the food, beverage, transport and construction-related industries. Meanwhile, real wages moderated to 2.1% (3Q: 4.3%) on slower hiring trends.

Stronger export and import growth

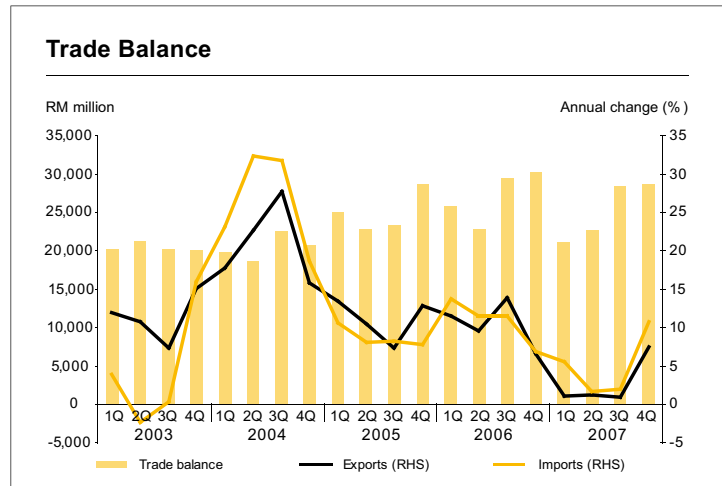
The **trade account** recorded a surplus of RM28.6 billion (3Q: RM28.3 billion). Export growth of 7.5% (3Q: 0.9%) reflected mainly higher agriculture and mineral exports while stronger import growth of 10.7% (3Q: 2%) was attributable to higher imports of intermediate and capital goods.

Gross exports strengthened by 7.5% in the fourth quarter of 2007 (3Q: 0.9%) due mainly to the marked increase in commodity exports amidst the substantial rise in commodity prices as well as the turnaround in manufactured exports.

Manufacturing exports registered a positive growth of 2.9% (3Q: -2%), driven by strong growth in selected resource-based industries, as well as the improvement in E&E exports attributable to the pick-up in demand for computers and parts from the US. Meanwhile, semiconductor exports grew at a moderate pace due to slowing demand from the European Union. Exports of resource-based products such as petroleum and rubber recorded robust performance supported by higher prices.

Growth momentum in **agriculture exports** continued to remain strong, due mainly to exceptionally strong growth in receipts from palm oil exports (66.2%) following rising prices. Palm oil prices strengthened to RM2,630 per tonne, representing an increase

of more than RM1,000 compared to the corresponding period in 2006. The rise in price was a result of stronger global demand for palm oil amidst lower supply of soybean



	2006		2007		
	4Q	Year	3Q	4Q	Year
	Annual change (%)				
Gross Exports	6.6	10.3	0.9	7.5	2.7
Manufacturing	5.7	10.1	-2.0	2.9	0.3
Agriculture	22.1	12.5	29.9	40.2	25.0
Minerals	0.5	8.6	6.6	23.6	8.1
Gross Imports	6.8	10.8	2.0	10.7	4.9
Capital goods	4.1	7.4	17.5	17.7	7.3
Intermediate goods	7.1	8.8	-0.7	13.3	6.8
Consumption goods	12.1	13.4	1.2	3.6	3.6
Trade balance (RM billion)	30.2	108.2	28.3	28.6	100.5

Source: Department of Statistics, Malaysia

oil and rapeseed oil in the US and Europe, respectively. Growth was also supported by increase in exports of rubber which benefited from higher prices.

Mineral exports also expanded further during the quarter, led mainly by higher crude oil exports and to a lesser extent increased LNG exports amidst higher prices. Export price of crude oil rose to an average of USD87.34 per barrel during the quarter (3Q: USD75.40) in line with developments in the global oil markets.

Malaysia: Direction of Exports

	2006		2007			2006		2007			2006		2007		
	4Q	Year	3Q	4Q	Year	4Q	Year	3Q	4Q	Year	4Q	Year	3Q	4Q	Year
	RM billion					Share of total exports (%)					Annual change (%)				
United States	27.8	110.6	24.5	23.4	94.5	18.3	18.8	15.5	14.3	15.6	1.0	5.3	-18.6	-15.8	-14.5
European Union (EU)	21.1	74.9	20.3	20.4	77.8	13.9	12.7	12.8	12.5	12.9	20.5	19.7	0.5	-3.3	3.5
Selected ASEAN countries¹	37.5	152.5	39.6	43.1	154.3	24.7	25.9	25.0	26.4	25.5	2.2	10.7	-0.6	15.0	1.2
North East Asia	28.2	109.1	31.0	33.6	120.5	18.5	18.5	19.6	20.5	19.9	4.4	10.0	4.9	19.1	10.4
<i>People's Republic of China</i>	11.7	42.7	14.6	15.5	53.0	7.7	7.2	9.2	9.5	8.8	11.9	21.1	15.0	32.5	24.3
<i>Hong Kong SAR</i>	6.8	29.1	7.3	7.7	28.0	4.5	4.9	4.6	4.7	4.6	-12.6	-6.6	-2.1	13.1	-4.0
<i>Chinese Taipei</i>	4.1	16.0	4.2	4.2	16.5	2.7	2.7	2.7	2.6	2.7	2.8	8.3	-7.5	1.6	2.6
<i>Korea</i>	5.5	21.3	4.8	6.1	23.0	3.6	3.6	3.1	3.7	3.8	17.4	18.6	1.0	11.4	8.1
India	5.4	18.8	5.7	5.6	20.2	3.6	3.2	3.6	3.4	3.3	30.1	25.5	8.3	2.5	7.6
Total exports	152.0	589.0	158.5	163.4	605.1	100.0	100.0	100.0	100.0	100.0	6.6	10.3	0.9	7.5	2.7

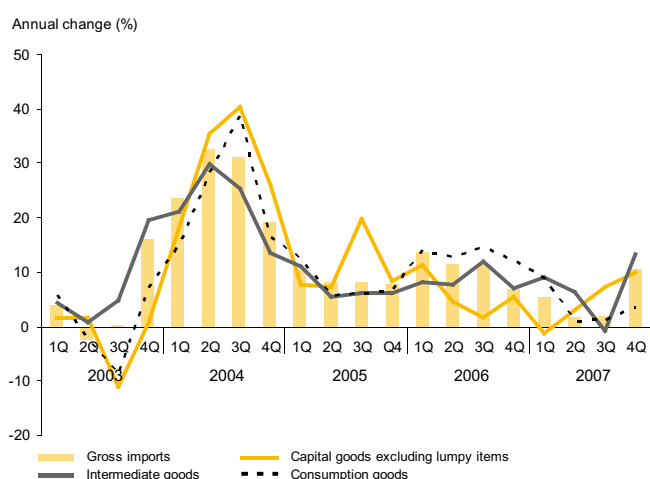
¹ Singapore, Thailand, Indonesia, Philippines, Brunei Darussalam and Vietnam

Source: Department of Statistics, Malaysia

Malaysia's exports to regional markets increased in importance. Strong economic activity in the Asian region (excluding Japan) led to higher regional exports (16.8%; 3Q: 1.8%). Exports to the ASEAN countries expanded strongly, driven mainly by higher exports of E&E products, iron and steel, minerals & fuels and plastics particularly to Singapore, Vietnam and Philippines. Export growth to the North East Asian countries strengthened, attributed mainly to higher demand for E&E products, LNG, and chemicals and chemical products. Meanwhile, exports to India comprising mainly of E&E and petroleum related products continued to grow.

Gross imports recorded a double-digit growth (10.7%; 3Q: 2%) during the quarter, reflecting growth in all major categories of imports. Of significance, imports of **capital goods** expanded by 17.7%. Excluding lumpy items, imports of capital goods strengthened by 10% (3Q: 7.4%). Infrastructure projects under the Ninth Malaysia Plan and development and production activity in the oil and gas sector spurred imports of construction and mining equipment. Capacity expansion and upgrading in the manufacturing sector led

Import Growth



to higher imports of machinery. Favourable agriculture prices continued to promote capacity expansion in the sector, leading to higher imports of agriculture equipment. Higher imports of ships reflected growing intra-regional trade and firm demand for commodity exports.

Imports of **intermediate goods** turned around to register a strong growth of 13.3% (3Q: -0.7%), reflecting imports of inputs for manufactured goods particularly in the E&E sector. Growth in the intermediate imports was also attributed to higher imports of primary and processed materials used by

the resource-based industry, such as metals and chemical products as well as fuel and lubricants. In addition, higher demand for motor vehicles supported the growth in imports of parts and accessories for transport equipment.

Consistent with continued growth in private consumption, imports of **consumption goods** expanded by 3.6%. Growth in consumption imports was mainly in food and beverages, as well as consumer goods, namely medicine, cosmetics, household furnishings and electrical goods.

interests of a local financial institution by a Hong Kong-based bank, as well as continued expansion in the wholesale and retail trade, restaurants and hotels sub-sector. In the manufacturing sector, FDI were channelled mainly into the E&E, downstream petroleum-related as well as chemical industries. Meanwhile, the bulk of the inter-company loans was in the form of short-term loans extended by foreign oil and gas companies to their subsidiaries in Malaysia and a large proportion of these loans was repaid during the same quarter. After adjusting for outflows due mainly to repayments of these short-term loans, net FDI amounted to RM3.3 billion (3Q: RM6.8 billion). The statistics for FDI on a 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		
	4Q	Year	3Q	4Q	Year
	Annual change (%)				
CAPITAL GOODS	4.1	7.4	17.5	17.7	7.3
Capital goods (except transport equipment)	4.6	5.4	10.4	10.2	5.7
Transport equipment	-0.1	23.5	95.3	78.5	17.7
INTERMEDIATE GOODS	7.1	8.8	-0.7	13.3	6.8
Food and beverages, mainly for industry	18.2	24.9	37.0	32.5	21.0
Industrial supplies, n.e.s.	19.2	11.1	8.3	15.6	17.0
Fuel and lubricants	-0.5	25.7	-20.1	32.7	2.0
Parts and accessories of capital goods (except transport equipment)	3.3	5.1	-5.6	5.7	0.4
Parts and accessories of transport equipment	-22.5	-8.7	22.0	37.2	11.3
CONSUMPTION GOODS	12.1	13.4	1.2	3.6	3.6
Food and beverages, mainly for household consumption	5.7	4.8	2.8	6.6	6.6
Transport equipment, non-industrial	45.7	9.4	55.8	1.0	9.3
Consumer goods, n.e.s.	15.1	18.8	-0.4	2.0	1.8
<i>Durables</i>	13.7	9.8	24.4	6.4	14.9
<i>Semi-durables</i>	24.5	34.6	-17.5	-7.4	-10.9
<i>Non-durables</i>	9.3	12.6	3.6	7.1	5.6
DUAL USE GOODS	-5.7	7.8	4.3	20.1	1.7
OTHERS	-3.4	-2.7	74.2	33.6	32.5
RETAINED IMPORTS	6.4	8.7	2.9	13.8	7.0
RE-EXPORTS	12.5	50.6	-11.3	-32.6	-22.4
GROSS IMPORTS	6.8	10.8	2.0	10.7	4.9

Source: Department of Statistics, Malaysia

Net inflows of FDI and portfolio investment

On a cash basis, gross inflows of **foreign direct investment (FDI)** amounted to RM12.8 billion (3Q: RM25.9 billion) reflecting mainly lower drawdown of inter-company loan from parent companies abroad. FDI in the form of equity capital remained high and was largely in the services, manufacturing, and oil and gas sectors. FDI in the services sector reflected mainly the acquisition of substantial

Gross outflows for **overseas investment** amounted to RM20.4 billion (3Q: -RM12.3 billion), reflecting mainly higher extension of short-term loans by non-resident controlled companies to their related companies abroad arising from their centralised treasury operations. These outflows were largely offset by inflows arising from repayment of short-term inter-company loans during the quarter. After adjustments for these transactions, overseas investment recorded a net outflow of RM5.1 billion (3Q: -RM7.1 billion). The bulk of the net outflows for overseas investment was effected by companies in the services, manufacturing, and oil and gas sectors. In the services sector, overseas investment were channeled mainly into the financing, insurance and business as well as utilities sub-sectors. Meanwhile, overseas investment by the manufacturing sector were led by companies in the electrical and electronics, metal products and petroleum-related industries.

Portfolio investment recorded a net inflow of RM6 billion (3Q: -RM21.9 billion) reflecting mainly net purchases of debt

securities by foreign investors which more than offset outflows due to purchases of equity securities abroad by residents. The net inflows of foreign funds reflected the shift in asset allocation to Asia.

External debt declined

As at end-2007, Malaysia's total external debt declined to RM187.4 billion (equivalent to USD56 billion) or 30.9% of GNP. The **medium and long-term external debt** increased marginally to RM133 billion (3Q: RM131.9 billion) as higher net drawdown by the private sector was partially offset by continued net repayment by the public sector and revaluation gain arising from the appreciation of ringgit against major currencies, particularly the US dollar. The Federal Government continued to register a net repayment (-RM0.9 billion; 3Q: -RM3 billion) reflecting largely the maturity of syndicated loans. During the quarter, the NFPEs recorded another net repayment (-RM0.4 billion; 3Q: -RM3 billion), attributable mainly to companies in the oil and gas as well as financial, insurance, real estate and business services sectors. The higher net drawdown of external loans by the private sector amounting to RM5.6 billion (3Q: RM4.1 billion) was effected largely by companies in the transport, storage and telecommunication, and manufacturing sectors.

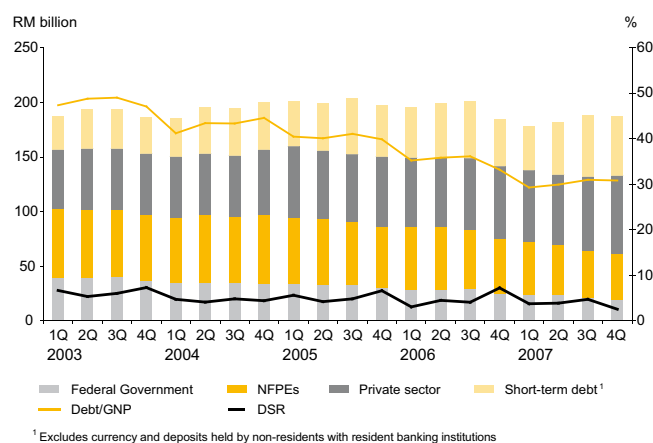
External Debt Outstanding

	2006	2007	
	4Q	3Q	4Q ^P
	RM billion		
Medium- and long-term debt	141.7	131.9	133.0
Public sector	75.4	64.2	61.4
Private sector	66.3	67.7	71.5
Short-term debt ¹	42.8	56.5	54.5
Total external debt	184.5	188.3	187.4
- USD billion equivalent	51.7	54.6	56.0

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

Source: Ministry of Finance, Malaysia and Bank Negara Malaysia

External Debt Outstanding



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

The total short-term external debt declined to RM54.5 billion (equivalent to USD16.3 billion), reflecting mainly lower short-term borrowings by the banking sector. As at end-2007, the short-term debt accounted for 29.1% of total external debt and 16.2% of the net international reserves.

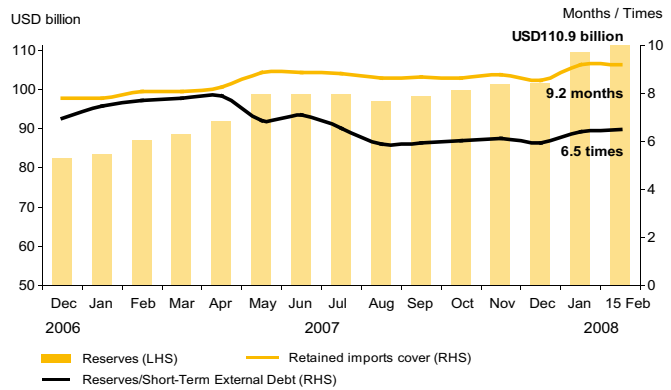
International reserves

The international reserves of Bank Negara Malaysia amounted to RM335.7 billion (equivalent to USD101.3 billion) as at 31 December 2007. The reserves level has taken into account the quarterly revaluation loss, following the strengthening of ringgit against the major currencies during the fourth quarter. The reserves increased to RM366.8 billion (equivalent to USD110.9 billion) as at 15 February 2008. The reserves position is sufficient to finance 9.2 months of retained imports and is 6.5 times the short-term external debt.

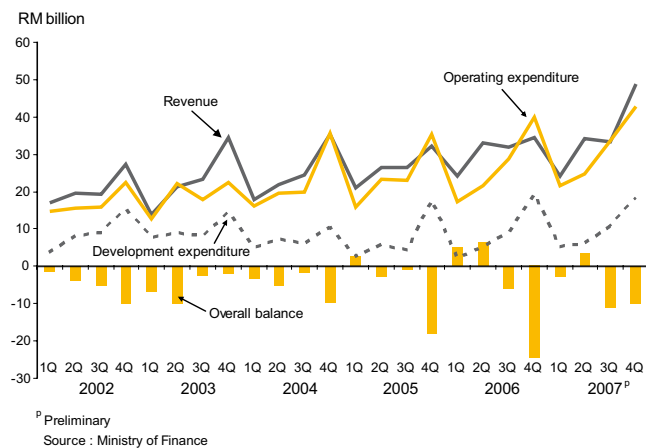
Fiscal deficit for 2007

The Federal Government's total expenditure in the fourth quarter was higher, resulting in an overall fiscal deficit of 3.2% of GDP for the year as a whole. In particular, higher development expenditure was recorded as a result of increased spending in the agriculture and public utilities sub-sectors. Meanwhile, increased revenue collection during the quarter was mainly from the higher corporate income tax collections and oil-related revenue. The fiscal deficit was funded largely from a drawdown of the realisable assets of the Government and domestic borrowings. As at end-2007, total outstanding debt of the Federal Government amounted to RM266.5 billion or 42.6% of GDP.

Net International Reserves (as at end period)



Federal Government Finance



Federal Government Finance

	2006	2007 ^P	
	4Q	3Q	4Q
RM billion			
Revenue	34.4	33.3	48.9
% growth	6.9	4.4	42.0
Operating expenditure	40.0	33.7	42.9
% growth	12.8	17.1	7.3
Current account	-5.6	-0.4	6.0
% of GDP	-3.8	-0.3	3.7
Gross development expenditure	19.4	10.8	18.2
% growth	11.0	19.0	-6.0
Overall balance	-24.6	-11.1	-9.8
% of GDP	-16.6	-6.7	-6.1
Memo item:			
Total gross expenditure	59.4	44.5	61.1
% growth	12.2	17.5	3.0
Total Federal Government debt (as at end-period)	242.2	271.5	266.5
% of GDP	42.3	43.4	42.6
Domestic debt	217.2	250.6	247.1
% of GDP	37.9	40.1	39.5
External debt	25.0	20.9	19.4
% of GDP	4.4	3.3	3.1

^P Preliminary

Source: Ministry of Finance

MONETARY AND FINANCIAL DEVELOPMENTS

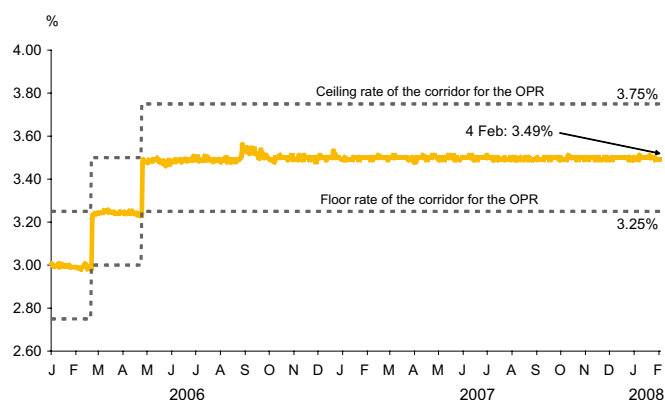
Interest rates were stable

The OPR remained at 3.50% throughout the fourth quarter of 2007, consistent with the medium term outlook of relative price stability and sustainable economic growth.

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

In terms of lending rates, the average base lending rate (BLR) of commercial banks (CBs) was unchanged at 6.72%. The average lending rate (ALR) on the other hand softened slightly to 6.29% as at end-December, compared with 6.30% as at end-September, as competition remained strong amidst ample liquidity conditions. The average quoted fixed deposit (FD) rates of CBs for tenures of between 1 to 12 months were unchanged, ranging between 3.08% and 3.70% at the end of the fourth quarter.

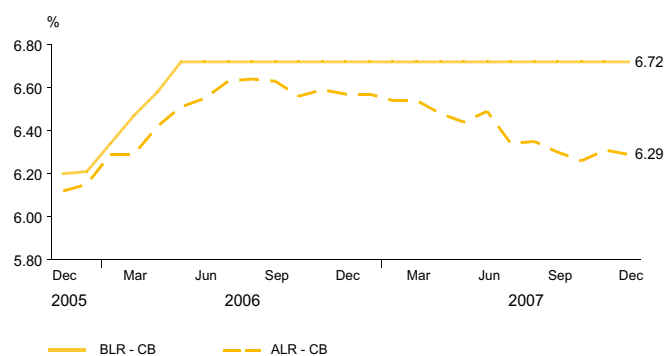
Daily Weighted Average Overnight Interbank Rate



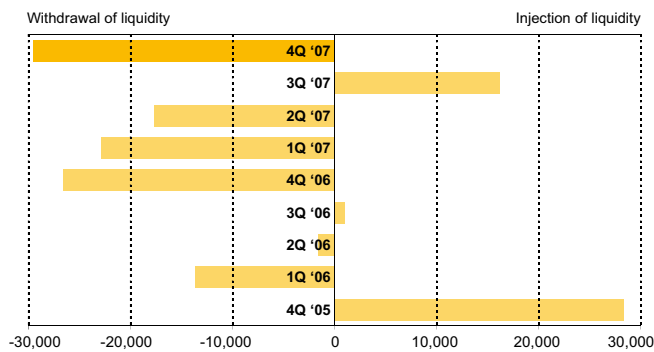
Interest Rates

	2006	2007			
	4Q	1Q	2Q	3Q	4Q
	At end-period (%)				
Overnight Policy Rate (OPR)	3.50	3.50	3.50	3.50	3.50
Interbank rates					
Overnight	3.50	3.50	3.50	3.50	3.50
1-month	3.58	3.55	3.54	3.54	3.54
Base lending rates (BLR)					
Commercial banks	6.72	6.72	6.72	6.72	6.72
Average lending rates (ALR)					
Commercial banks	6.57	6.54	6.49	6.30	6.29
Fixed deposit rates					
Commercial banks					
3-month	3.19	3.18	3.17	3.15	3.15
12-month	3.73	3.71	3.71	3.70	3.70

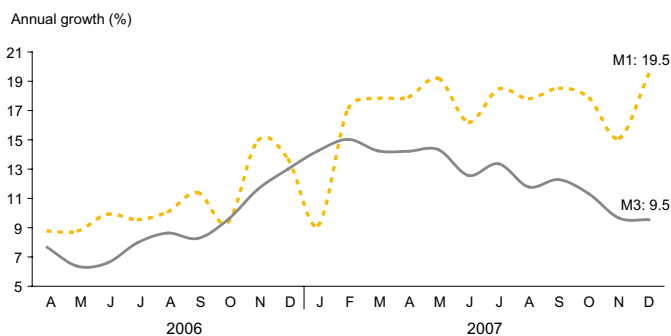
Lending Rates of Commercial Banks
(Average for the period)



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



Monetary Aggregates



Determinants of Broad Money, M3

	Change during the period				
	2006		2007		
	4Q	Year	3Q	4Q	Year
	RM billion				
M3	44.0	87.5	44.2	28.6	72.5
Net claims on Government	19.9	8.3	19.7	9.1	-0.1
Claims on private sector	7.9	34.7	25.9	-7.5	46.7
Loans	8.2	36.8	22.3	-8.3	43.2
Securities	-0.3	-2.1	3.1	0.8	3.4
Net external operations ¹	22.7	59.7	-1.7	20.0	76.4
BNM	5.2	32.1	-0.5	7.2	50.9
Banking system	17.4	27.6	-0.7	12.8	25.4
Other influences	-6.4	-15.3	0.3	7.0	-50.4

¹ Pre-revaluation

Source: Bank Negara Malaysia

Monetary aggregates continued to increase

In the fourth quarter, M3 or broad money rose by RM28.6 billion quarter-on-quarter or 9.5% on an annual basis. This increase reflected largely net trade and portfolio inflows during the quarter. Government operations were also positive on M3, reflecting a drawdown in Government funds with BNM to finance its outlays. The strength in M3 growth however was tempered by a reduction in loans outstanding after the repayment of a large syndicated bridging loan at the end of December.

M1, or narrow money, also increased, albeit at a faster pace compared to M3, due to higher demand for liquidity by businesses at the end of the year.

Financing continued to increase in the fourth quarter

Gross financing to the private sector by the banking system and capital market continued to increase in the fourth quarter, amounting to RM181.4 billion (3Q: RM170.1 billion). The increase in financing was due mainly to a large issuance of PDS to refinance a syndicated bridging loan contracted earlier with the banking institutions for funding of a privatisation exercise. On a net basis, banking system loans and PDS outstanding expanded at a combined annual rate of 8.3% at end-December (end-3Q: 8.9%).

Loan applications and approvals for the business sector in the fourth quarter were higher, reflecting stronger demand for funds to finance business expansion. Meanwhile, loan disbursements continued to be broad-based, with funds channeled to the manufacturing, wholesales and retail trade, finance, insurance and business services, as well as construction sectors. Financing to the SMEs remained significant, as evidenced by high levels of loan approvals and disbursements. Of the total loans disbursed, 25% were directed to the SMEs.

In the household sector, loan applications and approvals remained strong. This reflected sustained demand for loans for the purchase residential property and passenger cars, supported by rising household income, various incentives offered for the purchase of residential properties, as well as the revival of the car market.

Notwithstanding the repayment of a large syndicated bridging loan, total loans outstanding continued to expand at an annual rate of 8.6% at the end of the fourth quarter (end-3Q: 9.5%). Loans outstanding to businesses and households expanded at annual rates of 10.4% and 7.3% respectively (end-3Q: 14.8% and 7.3% respectively).

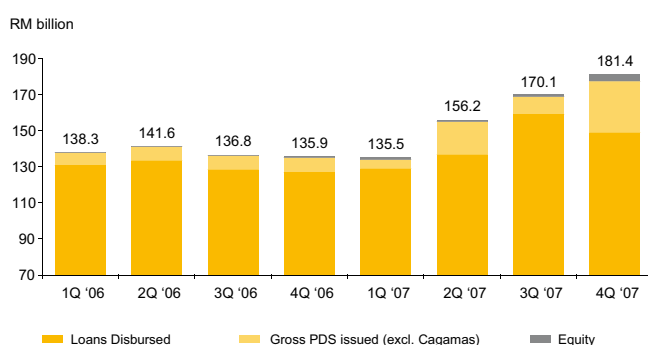
Financing of the Private Sector through Banking System and Capital Market

	During the period (RM billion)				Annual growth (%)		
	2006	4Q 06	3Q 07	4Q 07 ^a	2006	3Q 07	4Q 07 ^a
Gross total financing	552.6	135.9	170.1	181.4	-2.3	24.3	33.5
Loans disbursed*	519.9	127.2	159.3	148.9	-1.6	24.1	17.1
Gross PDS (excl. Cagamas)	30.7	8.1	9.6	28.7	-0.1	21.6	255.0
Equity	1.9	0.6	1.1	3.8	-69.7	119.4	504.0
Outstanding total financing (A)+(B)	45.5	6.4	28.7	2.5	6.2	8.9	8.3
Banking system	48.1	11.6	30.6	5.7	8.1	10.5	9.4
Loans outstanding (A)	34.9	4.1	30.9	-1.2	6.3	9.5	8.6
Holding of PDS	13.1	7.6	-0.3	7.0	37.3	25.3	20.1
PDS outstanding (B)	10.5	2.3	-2.2	3.7	6.0	7.0	7.6
Memorandum item							
Gross PDS (incl. Cagamas)	38.2	8.3	12.1	28.7	1.8	30.6	246.5

^a Preliminary

* Banking system loans include loans sold to Cagamas

Gross Private Sector Financing through Banking System and Capital Market



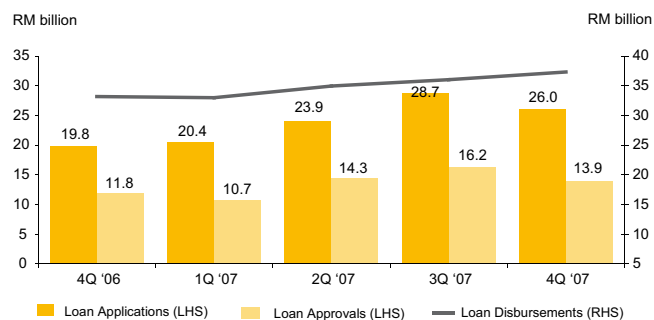
Loan Indicators

	During the period (RM billion)				Annual Growth (%)			
	2006	4Q 06	3Q 07	4Q 07 ^P	2006	4Q 06	3Q 07	4Q 07 ^P
Total								
Loan applications ⁿ	300.8	76.8	123.2	131.2	-1.5	6.3	55.4	71.0
Loan approvals ⁿ	188.3	49.7	74.4	87.9	-2.1	3.9	58.3	77.1
Loan disbursements ⁿ	519.9	127.2	159.3	148.9	-1.2	-5.8	24.1	17.1
Loan repayments ⁿ	478.2	122.4	123.8	152.1	-1.5	-2.6	5.1	24.2
Change in loan outstanding*	34.9	4.1	30.9	-1.2	6.3	6.3	9.5	8.6
Of which:								
Business enterprises**								
Loan applications ⁿ	161.0	41.3	68.3	77.3	4.8	16.2	60.5	87.3
Loan approvals ⁿ	96.3	28.1	41.1	56.7	8.7	22.0	79.1	101.8
Loan disbursements ⁿ	369.8	89.7	113.9	104.4	-1.2	-7.7	24.6	16.4
Loan repayments ⁿ	351.7	88.3	86.1	113.8	-3.9	-7.8	-0.5	28.9
Change in loan outstanding*	11.3	0.4	23.8	-9.8	5.0	5.0	14.8	10.4
SMEs**								
Loan applications ⁿ	71.4	19.8	28.7	26.0	20.0	55.9	47.0	31.5
Loan approvals ⁿ	40.2	11.8	16.2	13.9	14.9	48.9	55.6	17.0
Loan disbursements ⁿ	134.1	33.2	36.0	37.3	21.2	13.4	5.3	12.5
Loan repayments ⁿ	122.5	31.4	31.0	34.3	n.a.	n.a.	1.0	9.3
Change in loan outstanding*	8.7	0.1	2.9	2.2	9.1	9.1	7.0	9.0
Large corporations								
Loan applications ⁿ	89.6	21.5	39.5	51.3	-4.7	-6.0	71.9	138.7
Loan approvals ⁿ	56.1	16.3	24.8	42.9	4.7	7.8	98.8	163.6
Loan disbursements ⁿ	235.6	56.5	77.9	67.1	-10.7	-16.7	36.1	18.6
Loan repayments ⁿ	229.2	56.9	55.1	79.5	n.a.	n.a.	-1.3	39.6
Change in loan outstanding*	2.6	0.3	20.9	-12.1	2.0	2.0	21.0	11.6
Households								
Loan applications ⁿ	139.8	35.5	54.9	53.9	-7.9	-3.2	49.5	51.9
Loan approvals ⁿ	92.0	21.6	33.3	31.2	-11.3	-12.9	38.4	44.8
Loan disbursements ⁿ	150.2	37.5	45.4	44.5	-1.0	-1.2	22.9	18.7
Loan repayments ⁿ	126.6	34.1	37.7	38.3	5.6	14.1	20.7	12.3
Change in loan outstanding*	26.6	6.0	8.6	6.2	8.7	8.7	7.3	7.3

* The annual growth is for end-period
 ** Include loans to individual businesses
ⁿ Numbers may not add up due to rounding
^P Preliminary
 n.a. Not applicable

Source: Bank Negara Malaysia

Bank Lending to SMEs



Loans by Sector

	Loans disbursed					Loans out-standing	
	During the period				Share of total	Share of total	
	2006	4Q 06	3Q 07	4Q 07			
	(RM billion)				(%)		
Business enterprises	369.8	89.7	113.9	104.4	70.1	40.6	
<i>Large corporations</i>	235.6	56.5	77.9	67.1	45.0	22.9	
<i>SMEs*</i>	134.1	33.2	36.0	37.3	25.1	17.7	
Households	150.2	37.5	45.4	44.5	29.9	55.1	
Selected sectors							
Agriculture, hunting, forestry and fishing	13.9	3.4	4.1	3.5	2.4	2.2	
Mining and quarrying	2.0	0.3	0.4	0.6	0.4	0.2	
Manufacturing	118.9	30.6	34.7	34.8	23.4	11.6	
Construction	30.5	7.9	8.3	8.3	5.6	5.0	
Real estates	10.5	2.1	3.2	3.6	2.4	3.1	
Electricity, gas and water supply	2.9	0.4	0.3	0.4	0.3	0.6	
Wholesale, retail, restaurants and hotels	90.7	21.4	23.8	25.5	17.2	8.8	
Transport, storage and communication	10.3	2.8	19.6	5.2	3.5	2.4	
Finance, insurance and business services	42.1	9.6	10.0	11.8	7.9	6.2	
Consumption credit	100.4	24.7	29.5	29.6	19.9	23.6	
<i>Of which:</i>							
<i>Credit cards</i>	48.9	13.6	14.7	15.3	10.3	3.5	
<i>Purchase of passenger cars</i>	32.9	6.8	9.1	8.5	5.7	15.8	
Total	519.9	127.2	159.3	148.9	100.0	100.0	

* Include loans to individual businesses.

Source: Bank Negara Malaysia

Fund raising activity in the capital market remained high

In the fourth quarter, gross funds raised were higher at RM46.6 billion (3Q: RM26.6 billion). However, after adjusting for large redemptions, net funds raised amounted to RM567 million.

The public sector raised total gross funds of RM14 billion through four issuances of government securities. This included an issuance of 5-year Malaysian Government Securities (MGS) as well as re-openings of the 3-year, 5-year and 10-year MGS. Nevertheless, following higher redemptions in the fourth quarter, the public sector recorded a net redemption of RM5.9 billion.

In the private sector, gross funds raised amounted to RM28.7 billion. The bulk of the funds were raised from the private debt securities (PDS) market. The large issuance of PDS was due to an issuance by a large telecommunications provider to refinance its privatisation exercise. On the other hand, the private sector also recorded a high amount of redemptions in the fourth quarter. After adjusting for redemptions, net funds raised through the PDS market, excluding Cagamas, amounted to RM3.9 billion (3Q: RM755 million).

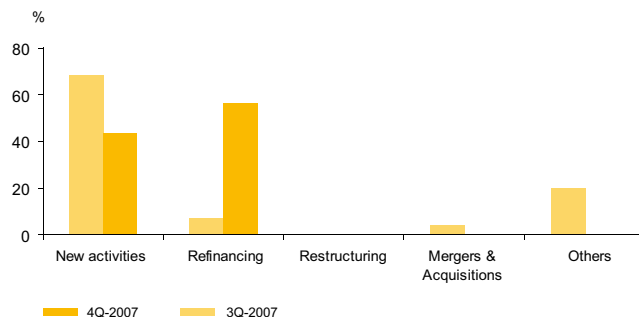
Funds raised through the equity market were higher during the fourth quarter, amounting to RM3.8 billion (3Q: RM1.1 billion). A total of RM1.0 billion (3Q: RM383 million) was raised through three initial public offerings (IPOs); one on the main board and two on the second board, while the remaining RM2.8 billion was raised through rights issues and warrants.

Funds Raised in the Capital Market

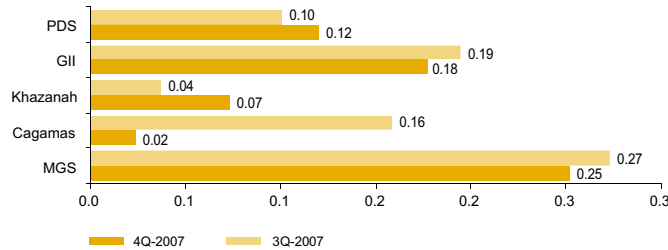
	2006		2007		
	4Q	Year	3Q	4Q	Year
RM million					
By Public Sector					
Government Securities, gross	6,500	26,830	9,924	14,048	43,187
Less Redemptions	2,850	12,850	-	19,600	24,400
Less Government holdings	-	-	-	-	-
<i>Equals</i> Net Federal receipts	3,650	13,980	9,924	(5,552)	18,787
Khazanah Bonds, net	1,070	(630)	-	-	(496)
Govt. Investment Issues, net	3,000	9,500	3,500	-	8,400
Merdeka Savings Bond, net	(433)	(1,931)	(386)	(394)	(1,513)
Net Funds Raised	7,287	20,919	13,038	(5,946)	25,178
By Private Sector					
Shares	632	1,916	1,136	3,819	7,126
Debt securities	8,297	38,887	12,057	28,746	69,356
<i>Private Debt Securities (PDS)</i>	8,097	31,737	12,057	28,746	67,606
Cagamas	200	7,150	-	-	1,750
Less Redemptions	8,747	31,519	13,702	26,052	56,182
Net Issues	(451)	7,368	(1,645)	2,694	13,174
<i>Net issues (excluding Cagamas)</i>	2,409	11,120	755	3,909	19,589
Net Funds Raised	182	9,284	(510)	6,513	20,300
Total Net Funds Raised	7,469	30,203	12,528	567	45,478
Short-term Papers and Notes, net ¹	653	2,563	(880)	(797)	86
Total	8,122	32,766	11,648	(229)	45,565

¹ Refers to Commercial Papers and Cagamas Notes only

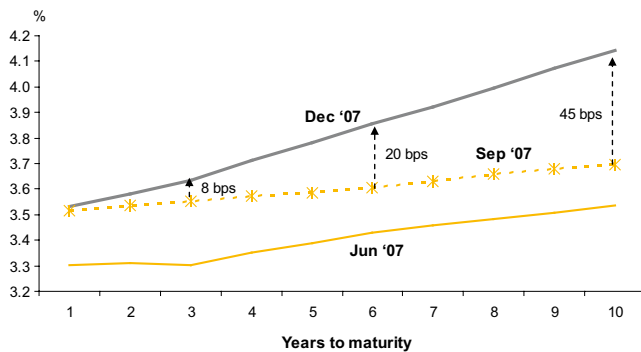
Private Debt Securities Issued by Purpose (% of total)



Liquidity Ratio: Turnover/ Outstanding



Trend in MGS Yield

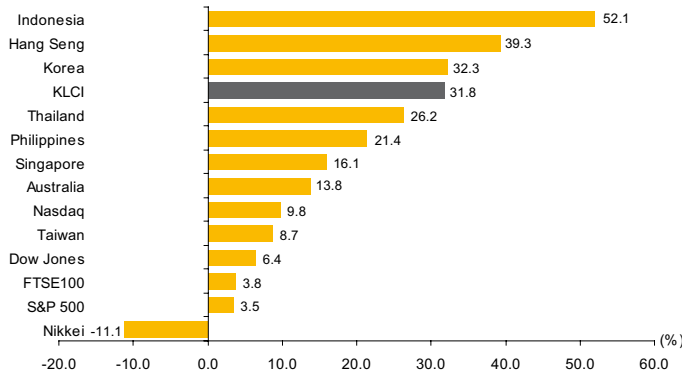


Secondary trading in the bond market remained high

Trading in the secondary bond market remained high at RM78.3 billion in the fourth quarter (3Q: RM81.3 billion). The bulk of the trade came from government securities (MGS and GII), accounting for 68% of the total trade, followed by private debt securities, which accounted for 31% of total trade. In terms of liquidity, the MGS was the most liquid paper, registering a liquidity ratio of 0.25, followed by the GII with a liquidity ratio of 0.18.

Expectations of higher inflation caused MGS yields to rise by 8 - 45 bps across all maturities. The spread between the 10-year MGS and the shorter and medium-term MGS widened and eventually led to the steepening of the MGS benchmark yield curve in December. However, as inflows continued to enter the bond market, the rise in the bond yields moderated.

Performance of Selected Global and Regional Markets (29 December 2006 - 31 December 2007)



KLCI rose to a record high in 4Q 2007

In the fourth quarter of 2007, sentiments in the Kuala Lumpur stock market remained bullish despite the negative sentiments arising from the US sub-prime market. The KLCI rose to a record high of 1,447 on 28 December 2007 due to the strong performance of the plantations sector in response to stronger crude palm oil prices, and also due to positive quarterly corporate earnings. Escalating

Bursa Malaysia: Turnover of Corporate Securities

	2006				2007					
	4Q		Year		3Q		4Q		Year	
	million units	RM million	million units	RM million	million units	RM million	million units	RM million	million units	RM million
Turnover	57,015	78,257	197,819	250,331	84,841	139,127	78,648	117,720	373,612	561,047
Of which:										
Main Board	36,338	66,458	121,666	204,801	62,160	127,213	50,667	106,134	262,912	501,933
Of which:										
Consumer Products	977	2,665	4,765	13,945	1,901	5,069	1,752	4,777	7,544	19,794
Industrial Products	4,474	5,395	16,232	17,747	7,220	11,812	4,906	8,213	28,788	43,299
Construction	2,787	5,262	11,107	15,807	6,334	15,975	3,486	9,748	22,413	55,618
Trading/Services	10,465	26,467	31,469	76,299	17,795	43,370	15,545	38,069	70,300	172,220
Finance	3,689	12,719	12,092	38,618	4,305	19,752	3,728	17,445	22,481	87,382
Properties	5,742	3,681	21,022	10,981	13,357	14,211	7,300	7,814	49,342	46,898
Plantations	1,004	5,516	3,384	17,190	1,734	7,542	2,177	9,658	7,356	36,549
Infrastructure	1,196	2,512	3,726	7,362	2,217	4,388	1,408	4,694	6,123	14,959
Second Board	5,432	4,023	21,914	16,617	6,818	5,265	7,254	4,707	34,122	23,097
Mesdaq	10,735	4,981	48,712	25,559	9,018	5,268	6,139	3,050	42,156	23,027

Source: Bursa Malaysia

Bursa Malaysia: Selected Market Indicators

	As at end				
	2006		2007		
	4Q	Year	3Q	4Q	Year
Price Indices					
Composite	1,096.2	1,096.2	1,336.3	1,445.0	1,445.0
FBM30 ¹	7,059.9	7,059.9	8,413.5	9,343.7	9,343.7
FBMEMAS ²	7,169.6	7,169.6	8,997.5	9,810.8	9,810.8
Second Board	92.0	92.0	105.8	-	-
Mesdaq	119.9	119.9	122.9	-	-
FTSE Second Board ³	-	-	6,945.0	6,732.4	6,732.4
FTSE Mesdaq ³	-	-	6,624.1	6,109.2	6,109.2
Average daily turnover					
Volume (million units)	934.7	802.9	1,326.7	1,268.5	1,548.4
Value (RM million)	1,282.9	1,018.9	2,176.3	1,898.7	2,345.7
Market capitalisation (RM billion)	848.7	848.7	1,031.3	1,106.2	1,106.2
No. of companies listed	1,027	1,027	1,001	987	987

¹ FBM30 stands for FTSE Bursa Malaysia 30 Index

² FBMEMAS stands for FTSE Bursa Malaysia Emas Index

³ With effect from 1 Sept 2007, the Second Board and Mesdaq indices have been replaced with the FTSE Second Board & FTSE Mesdaq indices.

Source: Bursa Malaysia

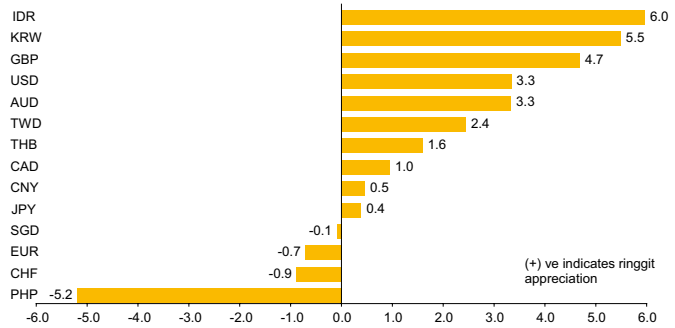
concerns of a downturn in the US economy, had implications on most major bourses, had some impact on the Kuala Lumpur stock market. The 50 basis points cut in the Fed Funds rate during the quarter helped to assuage market concerns and calm the major bourses. The KLCI benefited from this positive sentiment and rose to 1,445 at the end of the fourth quarter (since end-3Q: 8.1%). Market capitalisation was higher at RM1,106.2 billion (since end-3Q: 7.3%). However, trading activity decreased to a daily average turnover of 1,246.8 million units (since end-3Q: -5.4%).

On 26 February 2008, the KLCI closed at 1,375.4 (since end-2007: -4.8%), with market capitalisation lower at RM1,036 billion (since end-2007: -6.3%).

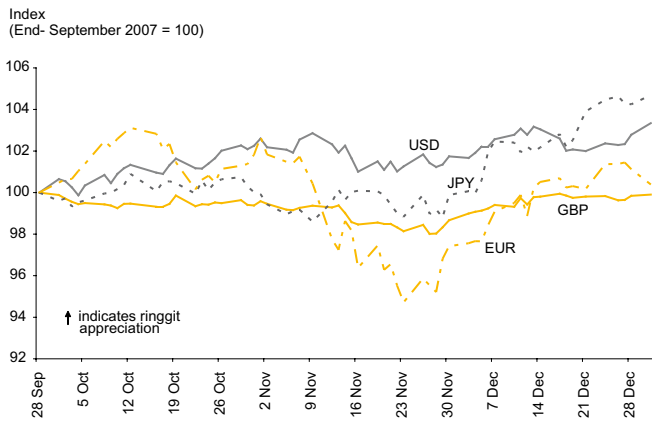
Exchange Rate Developments

The ringgit strengthened against the US dollar during the quarter arising from trade-related inflows and renewed portfolio inflows. For the quarter as a whole, the ringgit exhibited a mixed performance against major currencies, appreciating against the US dollar (3.3%) and the Japanese yen (0.4%), but depreciating against the euro (-0.7%). The euro strengthened due to market expectations of a widening interest rate differential in its favour. Against regional currencies, the ringgit appreciated in the range of 0.5% to 6.0%. The exception was the Philippine peso, against which the ringgit depreciated by 5.2%.

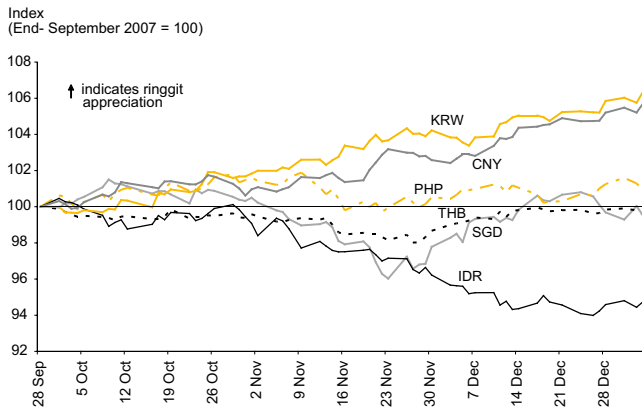
Summary of Ringgit Performance Against Selected Currencies Percent Change (1 October - 31 December 2007)



Ringgit Performance Against Major Currencies



Ringgit Performance Against Regional Currencies



The appreciation of the ringgit has continued into early 2008. Although the downturn in global equity markets and concerns about the impact of a slowdown in US economic growth on the region caused the ringgit to temporarily weaken against the US dollar in mid-January, it subsequently reversed following the 75 basis point cut in the Fed Funds rate by the US Federal Reserve on 22 January, and another 50 basis point cut on 30 January 2008. For the period 1 January to 26 February

2008, the ringgit appreciated against the US dollar and the euro by 2.9% and 2.3% respectively, but depreciated against the Japanese yen by 0.8%. The ringgit strengthened against most regional currencies, except the Thai baht and the Indonesian rupiah against which the ringgit depreciated by 1.5% and 0.4% respectively.

Performance of Ringgit Against Selected Currencies

RM per foreign currency	As at end				% change since*		
	21 Jul 05	4Q 06	3Q 07	4Q 07	21 Jul 05	4Q 06	3Q 07
US dollar	3.8000	3.5315	3.4170	3.3065	14.9	6.8	3.3
Euro	4.6212	4.6460	4.8410	4.8756	-5.2	-4.7	-0.7
Pound sterling	6.6270	6.9315	6.9167	6.6070	0.3	4.9	4.7
100 Japanese yen	3.3745	2.9675	2.9649	2.9534	14.3	0.5	0.4
Singapore dollar	2.2570	2.3028	2.2916	2.2938	-1.6	0.4	-0.1
100 Thai baht	9.0681	9.8111	9.9723	9.8159	-7.6	0.0	1.6
100 Philippine peso	6.8131	7.2027	7.5992	8.0158	-15.0	-10.1	-5.2
100 Indonesian rupiah	0.0386	0.0393	0.0373	0.0352	9.7	11.6	6.0
100 Korean won	0.3665	0.3797	0.3726	0.3532	3.8	7.5	5.5
Chinese renminbi	0.4591	0.4523	0.4548	0.4527	1.4	-0.1	0.5

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

DEVELOPMENTS IN THE BANKING SECTOR

The banking sector continued to demonstrate high resilience in the fourth quarter of 2007, supported by strong capitalisation and profitability. Coupled with the continued decline in the level of non-performing loans (NPLs), banking institutions are well-positioned to continue to support economic activities.

Banking institutions remained well-capitalised

The capitalisation of the banking system remained strong despite a slightly lower risk-weighted capital ratio (RWCR) and core capital ratio (CCR) of 13% and 9.9% respectively as at end of the final quarter of 2007. The marginally lower capital ratios were due to higher risk weighted assets (+RM19.7 million or +2.5%) in line with growth in lending activities which was cushioned by a marginal expansion in capital base by 1.5% following the issuance of subordinated debt capital and injection of capital by banking institutions.

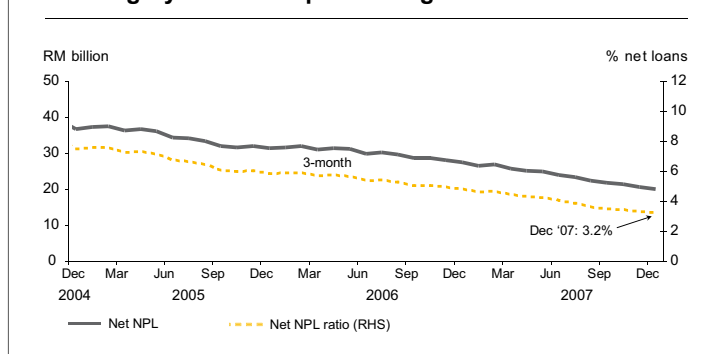
Banking System: Capital Position

	2006	2007			
	4Q	1Q	2Q	3Q	4Q
Capital					
CCR (%)	10.7	10.4	10.8	10.3	9.9
RWCR (%)	13.5	13.1	13.9	13.2	13.0

Profitability remained stable

During the quarter, the banking system registered a strong growth of 21% in unaudited pre-tax profit (PBT) to RM5.2

Banking System: Non-performing Loans



billion (3Q: RM4.3 billion). The favourable performance was attributed mainly to higher net interest income by RM0.4 billion (+6.2%) and net investment gain by RM0.2 billion (+35%), as well as lower loan loss provisions by RM0.6 billion (-48.6%) for the quarter. As a result, there was an overall expansion in PBT for the year by 34.8% to reach RM17.6 billion. Consequently, the return on average equity improved to 19.7% (3Q: 18.7%) while return on assets was sustained at 1.5%.

Continued decline in the level of NPLs

The NPL level of the banking system continued to improve during the quarter. Total net NPLs based on the 3-month classification declined further by 7.4% to RM20.1 billion (3Q: RM21.7 billion) as at end of the fourth quarter to account for 3.2% of net total loans (3Q: 3.5%). This was attributed mainly to the sale of NPL and higher reclassifications of NPLs to performing status and continued write-offs by banking institutions.

**Speech at the Islamic Finance Conference
“Islamic Finance in Southeast Asia: Local Practices, Global Impact”
Georgetown University, Washington D.C.
18 October 2007**

“Enhancing Interlinkages and Opportunities - The Role of Islamic Finance”

by

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

It is my great pleasure to be here in Washington D.C. to speak at this important conference which has brought together policymakers, market practitioners, members of the academia and the business community to discuss the new opportunities in Islamic finance and its role in enhancing international financial linkages. It is exactly five years ago, when I spoke on this very subject of Islamic Finance at the First International Islamic Finance Conference that was held in Washington D.C. in 2002. The issues discussed at that time were on the challenges faced in developing an efficient and robust Islamic financial system. Five years hence, the Islamic financial system has evolved significantly to become a dynamic and competitive form of financial intermediation in the global financial system. This transformation has been achieved in an increasingly challenging environment.

My remarks today will focus on this transformation that has taken place in these five years in both the national and international Islamic financial system. Most significant has been the development of the Islamic financial markets, the increase in the range of the financial products and services, the increasing significance of the international dimension of Islamic finance, the development of the international Islamic financial architecture, and the enhanced international inter-linkages that has been brought about by these developments.

Transformation of the Islamic financial landscape

As recent as five years ago, the development of Islamic finance was regarded as an infant industry striving to prove its viability and competitiveness. At that time, the growth of Islamic finance was organic and largely concentrated in countries where the Muslim population was significant. In these five years, Islamic finance has recorded dramatic growth and has a presence in more than 75 countries both in Muslim and non-Muslim dominated communities. There are also a growing number of the international financial centres that are beginning to offer Islamic financial products and services such as in London, Singapore and Hong Kong. The number of Islamic banking institutions worldwide including conventional banks that are offering Islamic banking services have doubled to more than 300. The total Islamic financial assets under their management is now estimated to exceed one trillion US dollars, about fivefold its magnitude five years ago.

Islamic finance is now among the fastest growing financial segments in the international financial system with an estimated average annual growth of between 15 to 20 percent. More recently, there has been a growing diversity in the range of products and services being offered and in the markets that have been developed. The sukuk market, that is the Islamic bond market denominated in

international currencies, has registered a remarkable growth, having doubling in size to amount to USD28 billion compared to a year ago. Including sukus denominated in domestic currencies, the size of the market is now about USD82 billion. This market is expected to continue to expand significantly given the massive financing requirements for infrastructure investment and other private sector investment by countries that have shown interest in Islamic funding.

There has also been significant innovation in Islamic financial products. This has been especially evident in the sukuk products. Following the Malaysian Government issuance of the world's first global sovereign sukuk in 2002, there has been several other sovereign sukus issued by other countries. This development has also encouraged the issuance of international corporate sukus by multinational and domestic corporations. Innovative instruments that have been developed include the landmark issuance in 2006 of the exchangeable sukuk by Khazanah Nasional, the Malaysian sovereign wealth management entity. In this arrangement, the sukuk can be exchanged for other shares held by Khazanah. In the same year, a convertible sukuk, in which the sukuk can be converted to the issuer's own shares upon initial public offering, was issued by a Middle Eastern-based corporation. The derivative market has also been developed with the introduction of Islamic currency swaps and profit rate swaps.

There has also been significant growth in Islamic asset and wealth management following the development of diverse and innovative structures of Islamic investment funds, including Islamic hedge funds. There are now more than 250 Shariah-compliant mutual funds that are managing an estimated USD300 billion in assets. Other developments include the creation of benchmark indices such as the Dow Jones Islamic Market Indexes - covering more than USD10 trillion market capitalisation in over 40 countries, the Financial Times Stock Exchange Global Islamic Index Series, and the listing of Islamic financial instruments on international

exchanges. These developments have enhanced the depth of the Islamic financial markets as an attractive asset class for investment.

Another important development in Islamic finance during this period has been the strengthening of the international Islamic financial architecture. In 2002, a major structural enhancement was the establishment of the Islamic Financial Services Board (IFSB), which formulates the international regulatory and prudential standards for Islamic finance. It has since issued the standards for capital adequacy, risk management and corporate governance. Among the standards that are currently being formulated include market conduct and rules for financial disclosure, transparency, the Shariah governance framework and the supervisory review process. This is to ensure best practices and the soundness and stability of the Islamic financial system.

The IFSB now has 137 members that include 35 regulatory and supervisory authorities, five international inter-government organisations including the BIS, World Bank and the IMF, and 97 market players and professional firms from 22 jurisdictions. Of significance to note is that the membership of the IFSB comprises several authorities and international institutions from the non-Muslim countries. The IFSB complements the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) which was established earlier in 1991, to set the accounting standards to ensure that the true and fair value are reflected in the financial transactions and to ensure greater accountability and responsibility of the financial institutions.

Finally, these developments have been reinforced by greater liberalisation to increase the international dimension of Islamic finance. With increased international participation in Islamic financial markets, it has prompted increased cross-border Islamic financial flows. In addition, Islamic financial institutions that had previously operated only in their own domestic jurisdictions have begun to venture

abroad to tap new growth opportunities in other regions. This new international dimension of Islamic finance has enhanced further the international inter-linkages in this more globalised environment.

Islamic finance: Operating in a challenging and evolving environment

The evolution and expansion of Islamic finance has occurred in a fast changing and dynamic international environment. In the context of a more challenging and competitive environment, the issue of financial stability, viability and competitiveness are paramount. This is particularly evident in the recent developments experienced in the international financial system. An important element of Islamic finance is the strength and soundness it derives from its Shariah principles. Islamic finance has an inbuilt dimension that promotes soundness and stability, underpinned by the Shariah injunctions. These Shariah injunctions essentially interweave the financial transactions with genuine productive activities.

The soundness and viability of Islamic finance as a form of financial intermediation is premised on the fundamental requirement that Islamic financial transactions need to be supported by an underlying productive activity. There is therefore always a close link between financial and productive flows. The financial transaction has to be accompanied by genuine trade or lease-based and business related transactions where interest is eliminated and profits or rentals are the economic rewards. Alternatively, the Islamic financial institution may enter into a joint venture as a means of financing, in which it becomes a joint partner in the economic activity based on a pre-specified profit sharing arrangement. In addition, there are also explicit restrictions on unethical and speculative financial activities.

The intrinsic nature of Islamic finance also encourages risk management and provides confidence through explicit disclosure and transparency of the roles

and responsibilities defined in the contract. In Islamic finance, strategies to minimize and manage the risks involve integrating the risks in the real activities. The real activities thus need to generate sufficient wealth to compensate for such risks. In contrast, conventional instruments generally separate the risks from the underlying assets. As a result, risk management and wealth creation may, at times, move in different or even opposite directions. Conventional financial instruments also allow for the commoditisation of risks, leading to its proliferation through multiple layers of leveraging and disproportionate distribution. This could result in higher systemic risks, increasing the potential for instability and inequitable concentration of wealth.

The intrinsic principle of governance also contributes towards insulating the Islamic financial system from potential risks from excessive leverage and speculative financial activities. The explicit and transparent nature of Islamic financial contracts and the greater disclosure of information are important in contributing to the stability of the system. The focus of Islamic investment also not only involves riba free activities but also extends to include issues related to ethical values and fair trade. The Islamic investment guidelines thus share a number of similarities with socially responsible investment (SRI) principles.

New opportunities and linkages offered by Islamic finance

Islamic finance is now at the threshold of a new dimension in which it has an increased potential role to strengthen international financial inter-linkages between nations. Islamic finance has the potential to contribute towards the efficient mobilization and allocation of funds across regions. Regions with surplus savings may channel funds to regions with deficit savings and to bring about a more inclusive global financial integration. Financial linkages are now gaining ground as intra-regional financial flows are increasing in significance. In this context, Islamic finance has become a new vehicle contributing to

increasing the financial linkages within Asia thereby facilitating cross-border allocation of capital in the region. However, it not only has a potential role in strengthening integration and linkages within Asia, but also more importantly in forging linkages with other dynamic emerging regions such as the Middle East.

Several economies within Asia are now beginning to participate in these trends thus strengthening further economic and financial linkages between these two dynamic growth regions. This enhanced inter regional linkages between Asian and the Middle East has created an environment of activity reminiscent of the Old Silk Road. This suggests that a New Silk Road has emerged in which financial services providers across continents now operate on this new route. While the New Silk Road reflects the linkages between Asia and the Middle East, the Silk Road has always been extended to the rest of the world. There is thus the potential for greater participation by global investors and the international financial community.

Islamic finance essentially presents value propositions for both investors and issuers in the respective markets, in particular, the sukuk market. For investors, Islamic financial products offer portfolio diversification and new investment opportunities in the form of new asset classes. For issuers, Islamic finance allows access to a new source of funds and liquidity besides providing, new risk management options and new mechanisms for price discovery. A number of international financial centres have recognised Islamic finance as an integral part of their financial markets in order to complete the suite of financial products and services available, and are therefore actively developing this segment. This trend is envisaged to stretch the New Silk Road from Asia and Middle East and extend to the West and to other parts of the world.

Further opportunities: The Sukuk Market

Among the more significant developments in Islamic finance in the recent period has been the development of the Sukuk market.

Although the size of the Sukuk market is modest by global standards, the Sukuk market has experienced remarkable growth, increasing at an average annual rate of growth of 40 percent. This growth is spurred in part by the growing funding requirements in emerging market economies, in particular, in Asia and the Middle East in which there has been increased investment activity. There has also been significant demand for the Sukuk spurred by the high levels of surplus savings and reserves in Asia and in the Middle East. This strong demand has also has been reinforced by the strong financial flows in the international financial system that is in search of higher returns and greater diversification of risks.

It has been estimated however that about 80 percent of the sukuk issued have been subscribed by conventional international investors. Besides the intrinsic value of the sukuk which are largely asset-backed, convertible for shares or exchangeable with shares, such issuances are attractive as they have a wider investor base that comprise conventional and Islamic investors. With the rising wealth of global investors seeking Shariah compliant investments the market has become highly competitive. More recently, it has prompted corporations worldwide including global multinational companies to consider this as a financing option.

The development of the sukuk market in Malaysia has involved extensive and wide ranging initiatives that include facilitating an efficient issuance process, enhancing the price discovery process, establishing of a benchmark yield, broadening of the investor base, promoting the liquidity in the secondary market and strengthening further the legal, regulatory and the Shariah framework. These initiatives have also been supported by the development of the financial infrastructure including the settlement system and the bond information system.

To position Malaysia as a centre for origination, distribution and trading of sukuk, further steps have been taken to liberalise the market to allow foreign corporations

including multinational corporations and multilateral agencies to raise funds in the Malaysian bond market. Funds raised by these entities may be used to finance investment activities in other jurisdictions. The inaugural ringgit denominated Sukuk issue was in 2004 by the International Finance Corporation, and followed by an issue by the IBRD World bank in 2005. In 2006, the market was further liberalized to allow foreign currency denominated sukuk to be issued from the Malaysian market. These sukuk issues have attracted foreign investors, thereby strengthening our inter-linkages with other international financial markets. Profits or income received by non-residents for investments in ringgit and non-ringgit Islamic securities issued in Malaysia are also exempted from withholding tax. In addition, the Government has granted tax neutrality measures to accommodate the sukuk issuance.

To further enhance Malaysia's international financial linkages with other parts of the world, the domestic Islamic banking sector was liberalised further in 2004 with the issuance of new licenses to foreign Islamic financial institutions. In addition, the allowed foreign shareholding in Islamic financial institutions was raised to 49 percent of the total equity in existing Islamic financial institutions. New licenses are also extended to entities to conduct Islamic banking business and takaful and retakaful business in international currencies. These institutions, which may have up to 100% foreign equity ownership, are given operational flexibility to be established as a branch or subsidiary and enjoy a tax holiday for 10 years under the Income Tax Act.

Concluding Remarks

The foundations for the sustainable global development of Islamic finance have now been put in place. Going forward, three key elements will be important in sustaining the current momentum. These include the investment in research and development and hence promote innovation, the development

of the pool of talent, and the greater use of technology in Islamic finance.

Islamic finance as an emerging form of financial intermediation would require tremendous investment in research and development to promote innovation. Of importance is to develop a broader range of Islamic financial market instruments that include instruments with equity ownership features, Islamic asset-backed securities, inclusion of permissible forms of credit enhancements as well as Shariah-compliant risk mitigating instruments. The development of an Islamic derivatives market for hedging is required for market-making activities to support the development of secondary markets. Malaysia has recently established a Shariah Scholar's fund to fund such research and development efforts. The fund also aims to promote greater engagement among the international Shariah scholars and thus provide a platform for deliberation on the Shariah compatibility of newly developed Islamic financial instruments and markets.

As Islamic finance continues its robust international expansion, an adequate supply of talent and expertise is vital to support the growth. While shortages in talent are now being felt, this is being addressed on several fronts. To develop the expertise to meet the increasing manpower requirements of Islamic finance, Malaysia has in 2006 established the International Centre for Education in Islamic Finance (INCEIF). It is envisioned that INCEIF acts as a professional certification body and education institute for post-graduates in Islamic Finance. Reinforcing this is the International Centre for Leadership in Finance (ICLIF) in Malaysia that provides for leadership and management programmes for the financial services sector including for Islamic finance.

As Islamic finance forges ahead, successful Islamic financial institutions will be those that have the scale and are able to exploit the full potential and opportunities that arise from the advances in information technology (IT). In embracing new leading

edge technology, the potential for the Islamic financial industry to provide new products and services will be enhanced. It also represents the potential to increase access through a wider range of new delivery channels, including enhancing efficiency while reducing costs for consumers and businesses. IT needs to be leveraged on in making strategic decisions in the alignment of the business, in elevating the institutional capacity and operational efficiency and strengthening risk management capabilities.

Despite the more challenging and dynamic environment we have seen, Islamic

finance has continued to emerge as a vibrant and resilient form of financial intermediation that is increasingly being embraced on a global scale to become an integral part of the international financial system. In the process of its development, it has further expanded the set of opportunities for the participation by the international financial community and thus increases the inter-linkages both within and between economic regions of the world. In enhancing these new linkages and greater integration, Islamic finance is envisaged to contribute towards unlocking new potentials that would bring mutual benefits, and in doing so, enhance our overall prospects.

**Malaysia Financial Exhibition 2007 at the Mid Valley Exhibition Centre
30 October 2007**

Opening Speech by

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

It is my pleasure to be here this afternoon at the Opening Ceremony for the Malaysia Financial Exhibition 2007 or MYFex2007, organised by PIDM, Perbadanan Insurans Deposit Malaysia. PIDM was established two years ago to reinforce the role of Bank Negara Malaysia in ensuring the soundness and stability of the financial system. PIDM forms part of the financial safety net and plays a crucial role in administering an effective deposit insurance system that promotes public confidence in the soundness of the banking system. Public Confidence is key to financial stability and to the efficient functioning of the financial system. In this context, PIDM is actively raising awareness about deposit insurance and this exhibition is an effort to frame deposit insurance within the larger scope of the financial landscape.

A financial system that is not firmly rooted in the public belief that it is safe and sound cannot hope to expand and evolve successfully. This confidence is enhanced with having an effective deposit insurance whose role is to act in the best interest of depositors. With an explicit deposit insurance system, depositors can have further certainty of the safety of their money at the banking institution as well as knowing that banking system has a strong element of protection that can be count upon.

The Malaysian financial sector has undergone significant transformation and progress since we launched the Financial Sector Masterplan in 2001. This is particularly most evident in the banking sector which has undergone restructuring, consolidation, and rationalisation. Gradual deregulation and liberalization has also altered the

financial landscape bringing with it improved performance and enhanced resilience. This has further matured the banking sector and paved the way for new areas of growth. Besides these tangible results, structural changes have also taken place in the form of the emergence of new entities, the increased presence of new international players and more diversified and developed financial markets. The advancement of deregulation and liberalization have also increased competition which has in turn resulted in further new business opportunities. Within the context of these developments, the banking sector has become an important pillar of strength of our economy.

One dimension that is growing rapidly in the context of these developments is the rise of consumerism. The improvement in the quality of life, the rising affluence and better education has resulted in a new generation of consumers whose financial requirements are becoming increasingly more sophisticated. This has resulted in a major reorientation of the banking industry to become consumer driven and to become more focussed on consumer needs. This has brought new financial products and services for consumers. The rise of consumerism demands that products and services can no longer be just generic but must now be tailored to meet consumers' evolving needs.

With the rise of consumerism, the need to create informed consumers is even more important. As the financial sector continues to rapidly evolve, offering sophisticated products and services to cater for greater and more diverse needs, consumers need to become even more financially savvy. While

the consumer has an important responsibility to become more informed, financial service providers, the regulators and the authorities have an important role to provide the enabling and conducive environment that nurtures consumer empowerment. Indeed, consumer empowerment begins with financial awareness and consumer education. This in part can be achieved through greater disclosure and by increasing the education outreach to consumers thereby enhancing their ability to make informed financial decisions.

This exhibition aims to provide an enabling platform for consumer empowerment. MYFex2007 is a conscious effort to raise financial awareness by bringing together the various entities in the financial system that includes the industry, regulators and other agencies that provide information, the avenues for redress and financial advice with the aim of creating financially informed consumers. In essence, this one stop centre creates a comprehensive opportunity for consumers to improve their financial literacy and for the financial players to engage the consumers.

An important thrust of our policies at the Central Bank is financial inclusion. This is to ensure that every economic activity, geographical region and segments of society have access to financial services thereby promoting a more balanced growth. Financial inclusion is supported through a number of strategies amongst which includes increased access to financial services, access to financial information and advisory services and consumer education. Currently, 98% of the adult population in Malaysia have a savings account. Given this greater financial inclusion, banks need to recognise their role and their special relationship with their customers. Customers expect banks to provide relevant financial information to them to ensure that they will be able make informed judgments.

Avenues for the public to seek redress is also an important part of the financial safety net. The Financial Mediation Bureau provides an alternative redress mechanism

between the service providers and consumers on financial disputes. In addition, with the objective of promoting prudent financial management, the Credit Counselling and Debt Management Agency offers free advisory services. This is to ensure the sustainability and resilience of the household sector. In addition, there is also the BNMLINK and BNMTELELINK at the Central Bank to provide a further interface with the public.

The objectives of financial inclusion can also be met with the support of banking institutions as the benefits would justify the effort. Banks and other financial institutions that approach their business strategies responsibly and with the consumer interest in mind will stand to reap long-term gains from enhanced franchise value, a strong reputation and positive association with socially responsible values that will engender public trust and confidence.

Public confidence is an important pre-condition for financial stability. Public confidence is however, not one that is created and expected to remain constant without making conscious efforts to enhance it. Public confidence must be created, nurtured and continuously enhanced by all the players in the financial sector working together through a range of approaches and strategies. This mandate requires a holistic and a collaborative effort of the authorities, financial service providers, private sector, educators and related associations that are here today.

I am delighted to note that MYFex2007 is one such effort. In the short 26 months it has been in existence, PIDM has gone beyond its statutory duty to create public awareness about deposit insurance and promoting public confidence in the resilience of the Malaysian financial system. They have embarked on a noteworthy initiative to contribute to financial system stability by organising a comprehensive financial awareness exhibition that seeks to create informed consumers with a view to contribute to financial system stability. I am pleased to see various Government agencies, the market players and related associations

and professional bodies participating in this important financial awareness initiative.

The vision for an effective, efficient and resilient financial sector requires the unified

efforts of all the stakeholders in the financial system. The financial players, the regulators, the Government and the consumers all have a meaningful role in achieving this vision. With this let me conclude my remarks.

**6th International Association of Deposit Insurers (IADI) Annual Conference
“Deposit Insurance and Consumer Protection”
31 October 2007, Kuala Lumpur**

Keynote Address by

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

As the international and domestic financial landscape continues to transform, the quest to secure financial stability has become increasingly challenging. Regardless of the stage of development, financial systems have continued to be vulnerable to crisis that have resulted in financial disruptions that have had severe economic repercussions. In these circumstances regulators and financial safety net frameworks have been tested to the limit.

While the rapid pace of globalisation, the rising internationalisation of the financial system and the advances in technology have brought benefits in terms of increased access to new markets, encouraging financial innovation and increasing consumer choice, it has also brought new risks to the financial system. The intensification of cross-border financing, and the growing complexity of financial structures has resulted in new international inter-linkages which has increased the international interdependence. The transmission of negative shocks in one country to others via the international financial system has demonstrated the potential for financial crises and economic disruptions to spread on a global scale. These concerns have been brought into the forefront recently with the developments in the sub-prime mortgage market in the United States and its contagion effect on financial systems in other parts of the world. Indeed, it has shown that in today’s globalised and increasingly internationally integrated financial markets, seemingly isolated events in a small segment in one market can have far reaching and vastly magnified implications in other financial markets across the world.

This recent episode of financial turmoil has shown that even the more sophisticated

and informed investors are pre-disposed to over-react to uncertainties in financial institutions. It also needs to be recognised that the changes in the international environment has also increased the challenges to understanding and managing risks, even for financial institutions and the authorities. These developments have also brought issues of the effectiveness of financial safety nets as well as institutional arrangements for the regulation and supervision of banks, to the forefront.

Elements of financial safety net

It is in this context that the components of the financial safety net, the prudential regulation and supervision, deposit insurance, liquidity support arrangements, crisis management approaches and the consumer protection framework - have continued to evolve over the recent decade. My remarks this morning will consider some of the developments and challenges that are shaping the calibration of the financial safety net in the current environment.

Prudential regulation and supervision

Sound risk management by banking institutions, which is reinforced by prudential regulation and supervision, remains the first line of defence against financial crisis. This recent decade has seen important strides being achieved at both the international and national levels towards strengthening the prudential regulatory and supervisory frameworks in response to the changing nature and scope of banking activities.

While lending and deposit-taking remain the mainstay of commercial banking,

the profile of credit markets has changed significantly. Today, conventional credit products are being offered alongside the growing significance of asset securitisation and credit derivative activities. This has had a profound impact on the nature of banking. The rapid development of these synthetic credit markets, coupled with an extended period of ample liquidity in the global financial system, has expanded the avenues for banks to engage in more aggressive lending practices that are funded by borrowing from the wholesale money markets, and by repackaging and selling loans to other investors in the form of asset-backed securities. This represents a significant shift from the more traditional banking models where loans are predominantly funded by deposits.

The increasing complexity in the way that debt is created and distributed in the financial system raises important implications for financial stability. The “originate and distribute” strategy that has been adopted by some institutions warrants addressing more comprehensively the full range of risks to which the banks are exposed. This includes the liquidity, foreign exchange and moral hazard risks in banking institutions. Credit risk exposures have also taken on more complicated forms, including counterparty risks on derivatives and foreign exchange transactions. The valuation of such financial transactions and instruments are also often difficult to measure particularly under distressed market conditions. In addition, the correlations between credit and market risk, both within and across national borders, have become more complex. Of concern has also been lack of adequate information on debt concentrations in the system partly due to the increasingly elaborate ways in which debt is passed on from originating institutions to different investors. The propensity to under-price credit risk, especially under conditions of excess liquidity, has also increased concerns over underwriting standards. The consequent sharp pricing corrections would in turn have the potential to result in broader economic disruptions.

Recent developments in the prudential regulatory and supervisory framework have, and will continue to play an important role in promoting sound risk management practices in the light of these changes. These of course, include the modification of capital standards that are more granular in addressing different types of risk. Supervisory approaches globally have also evolved to place a greater emphasis on sound risk management and early interventions to address emerging risks before they become major problems. There is also more emphasis being placed on the expectations of financial institutions to play a greater role in ensuring that financial products offered to customers and investors are suitable given their needs and financial circumstances, and that they have a good understanding of risks assumed with the products.

Bank Negara Malaysia’s approach to the financial regulation and supervision has similarly evolved to achieve a more robust regime that emphasises three key dimensions: first, creating a strong risk management culture that overlays the operations of banking institutions; second, facilitating market-led adjustments that will allow the industry to evolve in response to market and technological developments; and third, ensuring mutually consistent prudential policies across the financial sector.

Underpinning this approach has been a more pronounced shift towards principle-based regulations. Increasingly, regulations have focused less on prescriptive rules, and more on establishing broad parameters for sound financial and business practices that leave substantial flexibility for banks to apply the principles in the manner most appropriate to their specific circumstances. Of importance, has been the creation of appropriate incentives within the system to counteract potential market distortions that could undermine financial stability. The differentiated regulatory framework under which stronger banking institutions would have substantially greater operating flexibility and a lower level of supervisory intervention,

for example, provides a powerful competitive incentive for the adoption of sound risk management practices.

While enhanced bank regulatory and supervisory functions have had a direct and significant impact on improved risk management by banking institutions, the primary responsibility for sound institutional risk management will continue to rest with the boards and senior management of banks. It is the boards, and not supervisors, that are principally responsible for the performance of banks and for their financial strength. Boards set the tone for their institutions' risk taking activities, and provide effective oversight to ensure that their decisions are followed. Of paramount importance is the need for boards to ensure that risks are estimated in a consistent and timely manner, and escalated to the board with attention being focussed on the management of the emerging risks. Today, boards face additional challenges of discharging these responsibilities in an environment that is rapidly changing and highly competitive. Achieving effective boards and strengthening the foundations of sound corporate governance have therefore become a priority in the reform agenda for many countries in the recent period. The implementation of Basel II, new financial reporting standards and principles-based regulatory approaches have also significantly increased the importance of, and reliance on sound judgement, integrity and competence by the board and senior management. This, in turn has been a key driver in galvanising efforts to strengthen market discipline as a countervailing influence that will rein in high risk behaviour by banking institutions.

Achieving a framework with the right mix of regulatory and market-based incentives, however, continues to remain a significant challenge. Transitioning to market-based discipline can be particularly challenging in emerging markets where regulation has tended to be more prescriptive. In these markets, safety nets are also more prevalent and the tolerance for institutional failures is lower given its far reaching implications on consumer confidence. For the most part,

the liabilities of banks are not traded in the market, so debtholders generally lack the opportunity to exercise market discipline. Moreover, the market preoccupation with short-term stock price, rather than long-term creditworthiness also presents potential risks to financial stability.

Notwithstanding these challenges, several recent positive developments in emerging economies have augured well for market discipline to have a more effective role in reinforcing sound governance. In particular, the development of financial markets have resulted in more efficient markets with wide options for investors to exert discipline. The adoption of international financial reporting standards, efforts to strengthen auditor independence as well as financial capability initiatives will also reinforce market-based discipline going forward.

All of these initiatives will improve the prospects for financial stability by preventing problems from occurring at the level of individual institutions. However, the recent events in the international financial environment have demonstrated the increasing complexity of banking activities which has raised the broader challenges for financial regulation and the design of safety nets in the context of managing systemic risk. Regulators have begun to carefully consider the need to re-calibrate current regulatory approaches to appropriately address risks to the financial system stemming from large and complex institutions that are increasingly engaged in non-traditional activities. This has, in turn, placed new demands on financial regulators as well as for institutions to develop a deeper understanding of the inter-linkages between the financial system and the economy, and in particular, the macro-economic transmission of financial risk. Going forward, a more optimal balance of micro (that is, at the institution level) and macro (that is, affecting broader economy) responses will become increasingly important in the management of such systemic risks.

An important dimension to effectively manage the increasing inter-linkages between

the financial system and the economy involves the strengthening of cooperative arrangements between Central Banks and other regulatory authorities, within and across borders. Indeed, cooperation, coordination and goodwill have become essential in the increasingly integrated system. Such arrangements could include the more formal institutional arrangements for cooperation in surveillance efforts and crisis management, as well as the home-host arrangements for the supervision of international financial institutions, in supporting the early identification of risks and the pre-emptive interventions that need to be made. Cross border surveillance in the Asian region in particular has now been enhanced to ensure that information gaps are identified and that the mechanisms to facilitate information sharing are put in place.

Achieving effective inter-agency coordination between financial safety net participants also needs to be considered carefully in the context of crisis management. Inevitably, the task of managing a financial crisis particularly in the areas of timely decision making, coordination and communication become much more complex when the functions of lender of last resort, bank supervision and deposit insurance are allocated to separate agencies, as each respective agency is accountable for discharging its own mandate having regard to its own inherent priorities. Consequently, issues relating to information sharing, allocation of powers, responsibilities, accountability and coordination among the various agencies must be clearly and explicitly addressed at the outset. The legislative mandates would need to provide clear roles and responsibilities for each relevant authority. This will form the foundation for the adoption of an integrated and coordinated approach. The need for such coordinated action becomes particularly important in conditions of an imminent financial crisis. Having in place a crisis management framework would allow for its prompt and effective implementation. The issues relating to the effective management of the inter-relationships between the safety net

participants were brought to the forefront recently in the United Kingdom, testing the framework in which the functions of lender of the last resort and the supervisory function are placed in separate entities.

In comparison, when a single agent such as the central bank is entrusted with these respective functions, the interrelationship issue, as well as potential conflicts and trade-offs become internal and would be resolved across the organisation. It would nevertheless still need to rely on an adequate accountability regime among the respective departments or divisions that are responsible for each mandate.

Malaysia's own experience during the Asian financial crisis exactly ten years ago allowed the Central Bank as a single regulator, to promptly respond to the liquidity and solvency issues that were confronting the financial system. The preemptive action that was supported by a comprehensive resolution programme significantly reduced the cost of the crisis on the financial system and the overall economy.

More recently, the Central banks in the East Asian region have come together to put in place a comprehensive regional surveillance system that is supported by a comprehensive integrated crisis management framework that would deal with any imminent financial crisis in the region. These initiatives are aimed at effectively preventing or containing developments that could trigger destabilising consequences, thereby promoting regional financial stability.

Deposit insurance system

Following the restructuring and reform of our financial system, Malaysia has two years ago implemented the deposit insurance system as part of our efforts to build a cohesive and mutually reinforcing financial safety net system. The deposit insurance system has an important role not just in promoting confidence with explicit coverage of deposits, but also in reinforcing sound risk management practices. It therefore has embedded features

that complements the supervisory process in promoting sound risk management practices in the financial institutions. In addition, the deposit insurance corporation in Malaysia is also mandated with the responsibility for the 'least-cost' resolution of problem financial institutions.

A comprehensive approach was thus adopted in establishing the Malaysia Deposit Insurance Corporation (MDIC). To promote depositors confidence, the deposit insurance scheme was designed to ensure that there was optimum coverage with sufficient reach to retail depositors. In designing the deposit insurance scheme, about 95% of all depositors are covered in full while in value terms about 35% of total deposits is covered. An important element in the framework is the strong collaboration between the supervisor and deposit insurer in promoting discipline in the banking system. As the supervisor, recognition is given to sound risk management practices demonstrated by banking institutions to have greater business flexibility, while the deposit insurer, through a differential premium system, provides incentives for financial institutions to adopt sound financial and business practices.

In adopting this framework, clear accountabilities have been critical in ensuring that there is no duplication in efforts so that the banks would not be over burdened by overlapping regulation and submission requirements. There was also a need to ensure close co-operation and collaboration between the supervisor and the deposit insurer to ensure the intervention and resolution actions instituted by the deposit insurer, would not be to the detriment of the system as a whole. These resolution powers would be invoked by the deposit insurer following notification by the Central Bank that a member institution was likely to cease to be viable.

It is in this context, the strategic alliance between the Central Bank and the deposit insurer was formed as a basis for cooperation to ensure the safety and soundness of the financial system. In Malaysia, Bank Negara

Malaysia is mandated with the responsibility of safeguarding and ensuring the stability of the financial system. The overall supervision of the financial institutions remains within the functions of Bank Negara Malaysia. The Strategic Alliance Agreement with the Deposit Insurer provides for a structured collaboration between the Bank and MDIC to share information on key issues and developments to facilitate the operations of MDIC.

Both formal and informal information exchange mechanisms have been put in place to facilitate timely data and information exchange that can be leveraged upon to support and enable MDIC to fulfil its mandated role. This has proven to be effective in minimising duplication of efforts. These information exchanges include cooperation and consultations on supervisory and prudential regulations where both agencies are involved from the early planning stage, particularly in circumstances in which the initiatives impact the functions of the respective institutions.

Consumer protection framework

To complement the deposit insurance system, Bank Negara Malaysia has also put in place a comprehensive consumer protection framework that covers financial education, fair treatment of consumers, avenues for redress, distress management and rehabilitation as well as advisory services. These include having in place the Financial Mediation Bureau to ensure that consumers of financial services that are under the purview of the Central Bank have recourse to a fair and impartial dispute resolution mechanism. The establishment of the Credit Counselling and Debt Management Agency provides individuals with credit counselling and assistance in restructuring of debts; and the establishment of the Bank Negara Malaysia LINK and BNMTELELINK forms an integrated customer service centre for members of the public and small and medium sized enterprise on matters relating to services provided in the financial sector. This has evolved a high rate of participation in the financial system with deposits now accounting for 160% of GDP.

This has allowed for the efficient functioning of the intermediation process to effectively mobilise and channel savings to productive activity thereby supporting the overall growth and development process.

Conclusion

Ladies and gentlemen

Essential to a progressive financial system is prudential safety and soundness, competition and consumer protection which needs to co-exist to effectively serve the interests of various stakeholders. As regulators we

need to adopt the right balance between providing adequate protection for consumers while promoting competition and financial innovation in the financial system. But it is the combined efforts of regulators, the industry, and consumers that ultimately maintain market confidence and ensures the effective and efficient functioning of the financial system. The recognition of, and commitment to this shared responsibility will not only contribute to the evolution of the financial landscape and preserving financial stability, but will enhance its overall contribution to the overall functioning of the economy and securing its full potential.

**2nd Islamic Financial Services Forum : The European Challenge
“Islamic Finance: Approaching New Horizons”
5 December 2007, Radisson SAS Frankfurt, Frankfurt, Germany.**

by

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

This decade has witnessed the dramatic transformation of the financial services industry driven by the forces of globalisation, advances in technology and the increased pace of innovation. The financial sector has also been confronted with increased vulnerability to turmoil, distress and periodic crisis. Financial intermediation that is vital to the economic growth process has become intensively more complex and challenging. In the context of this environment, Islamic finance has continued to evolve as a viable and competitive form of financial intermediation. More recently, this trend has gained momentum. Islamic finance is now among the fastest growing segments in the financial services industry.

The viability of Islamic finance has been derived from its ability to meet the changing demands of the economy and from its cost competitiveness. Its development has also been supported by a well developed legal, regulatory and supervisory framework that has been important in ensuring its soundness and stability. Also important has been the efforts to bring about harmonization in the development of Islamic finance across the different jurisdictions. Finally, and most importantly, the principles of governance, risk management and transparency which are explicitly embedded in Islamic finance have provided the foundations that have contributed towards ensuring its viability and sustainability.

More recently the development and expansion of the Islamic financial services industry has entered into a new phase of development following increased liberalisation. This trend has fostered the shift from a domestic centric approach to

entering into transborder ventures in terms of greater financial presence in other jurisdictions as well as the higher level of participation in the Islamic financial markets, resulting in increased cross border flows. This has contributed to enhancing international financial inter-linkages between the different respective economies.

It is my honour to be here in Frankfurt to speak at the ‘2nd Islamic Financial Services Forum: The European Challenge’ jointly organized by Islamic Financial Services Board (IFSB) and the Financial Stability Institute (FSI), supported by the Deutsche Bundesbank. My remarks today will elaborate on the factors that have fostered the development and remarkable expansion of the Islamic financial services industry. My presentation will also touch on Malaysia’s experience in the development of a comprehensive Islamic financial system that is now being increasingly integrated into the international financial system.

Islamic Finance in a Challenging Environment

The very fundamental requirement of Islamic finance is that financial transactions must be accompanied by genuine trade and productive activities. In addition, the involvement in illegal, unethical and speculative activities is prohibited. It is in this respect that Islamic finance has the element of stability. At the same time, Islamic finance also promotes more equitable distribution of wealth arising from the various modes of Islamic financing contracts that ranges from a simple mark-up contract to the more equity-based contracts of mu-da-ra-bah (profit sharing) and mu-sha-ra-kah (profit and

loss sharing). Today, most of these Islamic financial contracts have been used in many business engagements in various respective financial sectors such as banking, insurance, capital and money markets.

Fundamental to Islamic finance is that the risk is shared by the financier (lender) and the customer (borrower). In such an arrangement, due diligence becomes essential. Under this risk sharing principle, Islamic financial institutions share the profits or the losses incurred by the entrepreneur. Hence, both are accountable for the performance of the enterprise. Thus, strategies to minimize and manage the risks in Islamic finance involve integrating the risks associated with the real activities. The real activities will need to generate sufficient wealth to compensate for the risks. In contrast, conventional instruments generally separate the risks from the underlying assets. As a result, risk management and wealth creation may, at times, move in different or even opposite directions. Conventional financial instruments also allow for the commoditisation of risks, leading to its proliferation through multiple layers of leveraging and disproportionate distribution. This could in turn result in higher systemic risks, increasing the potential for instability and inequitable concentration of wealth.

In Islamic finance, transparency represents a basic tenet underlying all Islamic financial transactions. There is an inherent obligation on Islamic financial services providers to meet certain standards of transparency. It is from the unique profit-sharing feature of Islamic financial transactions that it imposes a high level of disclosure, which is explicit in the financial contract. In addition, the role and responsibilities of the financier and customer are clearly defined in the contract. This transparency provides a strong incentive for Islamic financial institutions to appropriately manage risks. The disclosure also allows the market to assign appropriate risk premiums to the respective companies and thus enforce the potential to market discipline. This provides the foundations for the enhanced

role of market discipline to take effect, thereby promoting financial stability.

The adoption of governance best practices is also inherent in Islamic finance, given the wider range of contracts entered into between the Islamic financial institutions and their customers. As a partner, the Islamic banks must oversee the quality of the corporate governance, not only for achieving the business performance but also ensuring the accountability. The principle of governance embedded in Islamic finance also contributes towards insulating the Islamic financial system from potential risks associated with excessive leverage and speculative financial activities. This governance framework is also reinforced by the Shariah board or committee which represents another stratum in the governance structure which serves to ensure that the management of the Islamic institution is in compliance with the Islamic principles. These elements provides inbuilt checks and balances which serves to ensure financial stability in the Islamic financial system.

Islamic Finance and Financial Stability

The development and expansion of Islamic finance has also been accompanied by the development of the robust and comprehensive regulatory and supervisory framework. With the establishment of the Islamic Financial Services Board (IFSB) five years ago, Islamic finance has made remarkable progress in the advancement of having its own prudential and regulatory standards to govern its operations. The standards that have been issued by the Islamic Financial Services Board have taken all aspects of capital adequacy, risk management, corporate governance, transparency and market discipline and the supervisory review process as to ensure that Islamic banking institutions are well positioned to address all the risks associated to various types of Islamic financial contracts.

While these standards are consistent with the conventional standards, efforts have

also been taken to minimise any potential for regulatory arbitrage between conventional and Islamic financial system so as to avoid undermining the stability of the overall financial system. The IFSB also engages and also interfaces with other international standard setting bodies specifically BIS, BCBS, IOSCO, IAIS and FATF to ensure within the context of financial supervision and surveillance, similar risks are monitored and dealt with in a consistent manner so that there are no gaps in the overall supervisory processes. At the same time, tax and legal reforms are also being undertaken in a number of jurisdictions to accommodate the unique characteristics of Islamic financial transactions.

Against this backdrop, the Islamic financial industry has become one of the fastest growing financial segments in the international financial system with an estimated annual growth in the region of 15 to 20 percent. There is also a growing number of the Islamic financial institutions that now operate in several parts of the world both in Islamic and non-Islamic countries. The total Islamic assets under management are estimated to exceed one trillion US dollars. Islamic mutual funds are estimated to be at a value of over USD300 billion while the issuance of sovereign and corporate sukuk has now exceeded USD80 billion.

The rapid evolution and expansion of Islamic finance is also evident from the growing range of Islamic products and services with the Islamic financial solutions being developed to meet the demands of different consumer and business segments. This has been accompanied by the development of a diverse number of Islamic financial intermediaries including banking, takaful (Islamic insurance), capital market intermediaries and other specialized institutions that offer Islamic financial products and services. Such specialized institutions include mortgage corporations, credit guarantee corporations, deposit insurance, Islamic hedge funds, and other shariah compliant collective schemes such as Unit Trusts, Real Estate Investment Trusts (REITs)

and Exchange Traded Funds. We have also seen the rapid evolution of the Islamic financial markets including the Islamic money and capital markets with the development of a wide range of structured products and significant growth in activity.

Backed by its strong foundation and the growth that has been experienced, the Islamic financial services industry is now at a new threshold to make further advancement while at the same time to address some of the gaps that still exist. Of particular importance, is that the robust development of the Islamic financial markets needs to be reinforced by the development of risk mitigating instruments, increased product innovation and the continuous awareness of these developments by society at large, businesses, the financial services industry and regulators.

The evolution of sophisticated Islamic financial products which have been structured based on multiple Islamic concepts will allow us to start venturing into a new wave of innovation that will evolve Islamic financial instruments into distinct products and services that will maximize its potential. These products have already become competitive, flexible and efficient both from the perspective of pricing as well as product structure so as to cater to the demands of the business communities. The recent innovations that include the introduction of Islamic hedge funds, the creation of Islamic benchmark indices and the listing of Islamic financial instruments on the international exchanges have enhanced the depth of the Islamic financial markets as an attractive asset class for investment.

Sukuk: A Fast Emerging New Asset Class

The sukuk market is fast emerging as the most significant form of Islamic financing and continues to receive strong interest as an avenue for fund raising and investment. The sukuk market has been gaining growth momentum, increasing at an average annual rate of 40 percent with the current outstanding issuance estimated at USD 80 billion.

Significantly, 90 percent of the sukuk issuance are corporate issuances. Strong demand for sukuk have also been spurred by the high levels of surplus savings and reserves in Asia and the Middle East. In Malaysia, the issuance of sukuk has surpassed the issuance of conventional bonds for three consecutive years, with the annual turnover in sukuk trading in the secondary market at about RM135 billion.

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

Malaysia's Experience in the Development of Islamic Finance

Let me take this opportunity to share with you Malaysia's experience in developing our Islamic financial system. Over two decades, Malaysia has developed a comprehensive Islamic financial system that operates in parallel with the conventional financial system. The domestic Islamic financial system is now well-supported by a significant numbers of diverse players in the banking, takaful and the capital market. A robust regulatory and supervisory framework, as well as a legal and

Shariah governance framework have also been put in place. There is now also a high degree of consumer awareness on Islamic finance. In addition, there is also an efficient settlement and bond information system. The Islamic financial industry has been expanding at a double digit growth rate and has registered a market share of more than 12 per cent in the banking sector while the Islamic capital market in Malaysia has evolved as one of the largest in the world. More than 60 per cent of global sukuk market originates out of Malaysia. In the equity market, 86% of the listed stocks are Shariah compliant with market capitalization of USD193 billion. Malaysia has also structured the first Islamic real estate investment trust (Islamic REIT) listed on the stock exchange.

Following the development of a robust domestic Islamic financial system, initiatives have now been taken to raise the significance of the international dimension of the Islamic financial system. Malaysia has therefore implemented wide ranging liberalization measures, including the issuance of three new Islamic banking licences to foreign Islamic players that have come from the Middle East and through increasing the strategic stakes possible by foreign interest in our Islamic financial institutions, to up to 49 per cent. In the area of Islamic fund management, licences will be issued to entities with foreign equity of up to 100 per cent.

Our foreign exchange administration rules have also been progressively liberalized. In this regard, liberalization of capital account through the removal of restrictions to foreign exchange transactions have increased foreign participation in our financial markets. In addition, foreign corporations may raise funds either in ringgit or foreign currency out of Malaysia. The participation of foreign investors in the Malaysian bond market has also been increasing and now represents about 13% of the total outstanding debt securities. The increased foreign participation has also widened the investor base to extend beyond the Muslim countries. Participation in the equity market now represents about 20 per cent of the market. The increased

foreign participation has strengthened our interlinkages with other international financial markets.

Conclusion

In conclusion, Islamic finance is emerging as a viable and sound financial intermediation. The new wave of innovation and the increased awareness and interest in Islamic financial solutions are contributing to its dynamic advancement. The acceleration of the integration of Islamic finance into the international financial system would also

contribute towards strengthening further the global economic and financial inter-linkages and we believe increases the prospect for securing more balanced global growth. In addition, the increased diversification of cross border flows into new asset classes would not only result in the more efficient allocation of resources across borders but also enhance the potential to contribute towards global financial stability.

On this note, I wish you a productive and successful forum.

CALENDAR OF EVENTS October-December 2007

18 October 2007

At the Islamic Finance Conference “Islamic Finance in Southeast Asia: Local Practice, Global Impact” in Washington D.C., Governor stated that Islamic finance has the potential to become the “New Silk Road” that will enhance economic and financial linkages not only between Asia and the Middle East but also with the rest of the world. She added that Islamic finance can contribute towards the efficient mobilisation and allocation of funds across regions whereby regions with surplus savings may channel funds to regions with deficit savings to bring about global financial integration.

29 October 2007

The Bank and Hong Kong Monetary Authority (HKMA) announced the implementation of cross-border delivery-versus-payment (DvP) link between Hong Kong’s US dollar real time gross settlement (RTGS) system and Malaysia’s RTGS system. The DvP link will help eliminate settlement risk of US dollar bonds issued and traded in Malaysia by ensuring simultaneous delivery of US dollars in Hong Kong and US dollar bonds in Malaysia. The DvP settlement services provide the necessary settlement infrastructure to support potential issuance of US dollar bonds in Malaysia, as part of the initiatives to promote Malaysia as an Islamic financial centre and Hong Kong as an international financial centre.

30 October 2007

At its seventh meeting, the Bank’s Monetary Policy Committee (MPC) decided to leave the Overnight Policy Rate (OPR) unchanged at 3.50 percent. The Committee said that while downside risks to global growth may have an adverse impact on the Malaysian growth outlook, the strength of domestic fundamentals will have a mitigating role in reducing the impact. It added that at below two percent, the current inflation rate was among the lowest in the region and although further upward price adjustments may occur, overall inflation is still expected to be contained. Subsequently, at its meeting on 26 November, the Committee maintained the OPR at the same level and it also approved the schedule of MPC meetings for 2008.

At the Malaysia Financial Exhibition 2007 organised by Malaysia Deposit Insurance Corporation (PIDM), Governor said that financial inclusion is an important thrust in the Bank’s policies to ensure that every economic activity, geographical region and segments of society have access to financial services.

13 November 2007

The Bank and Ministry of Domestic Trade and Consumer Affairs announced the introduction of a rounding mechanism to the nearest 5 sen for over-the-counter payments to be fully implemented effective 1 April 2008. The implementation of the Rounding Mechanism is expected to benefit both consumers and businesses whereby consumers will be able to make convenient and faster payments while businesses will be able to reduce handling costs. The 1 sen coin will continue to remain a legal tender.

28 November 2007

The Bank announced that the Malaysian economy strengthened further by 6.7% on an annual basis in the third quarter of 2007, led by sustained strong domestic demand. Domestic demand was supported by strong private consumption spending and investment activities and this was reinforced by increased public sector spending. On the supply side, growth was led by the services sector.

The Bank also announced further liberalisation of the foreign exchange administration rules to facilitate foreign exchange transactions by resident companies with export earnings. With immediate effect, resident companies with export earnings are allowed to pay another resident company in foreign currency for the settlement of goods and services. The liberalisation is to enhance Malaysia's competitiveness by reducing the cost of doing business and the exchange rate risk of businesses while enhancing efficiency in cash management by resident companies.

21 December 2007

The Bank announced the issuance of a new design for the RM50 banknote to commemorate Malaysia's 50th Anniversary of Independence. This RM50 new design is the first denomination of the Fourth Series of Malaysian currency notes which will be replacing the existing series in stages. The main theme of the design is based on the National Mission where the first thrust is "to move the economy up the value chain" which reflects Malaysia's economic transformation to the higher value-added activities in the agriculture, manufacturing and services sectors of the economy.