Economic Research

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MALAYSIAN RATING CORPORATION BERHAD
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The State of Sarawak

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In a nutshell

- Sarawak's economy generally moves in tandem with the national trend. However, despite Malaysia's favourable economic growth performance which accelerated to 5.6% in 2012, Sarawak's real gross domestic product (GDP) growth unexpectedly slowed to 1.5% compared with a 5.8% expansion in the preceding year (Malaysia: 5.2%). The slowdown was mainly due to a 7.8% drop in the output of mining and quarrying, resources which the state is heavily reliant on for growth (the mining and quarrying sector's share of the economy was more than double the national percentage, at 21.1% in 2012 versus Malaysia's 8.4%). The services sector, which accounted for the largest share of the economy (36.8% of GDP in 2012), contributed 2.2 percentage points to Sarawak's overall economic growth for that year. Weak economic performance was also compounded by lower contribution from the manufacturing sector, which added a mere 0.2 percentage point to the growth in 2012, accounting for 27.0% of the economic pie, almost the same as the national economy (Malaysia: 24.8%). The state's share to the national GDP stood at 9.6% in 2012, the third-largest after Selangor (23.5%) and Kuala Lumpur (15.2%).

- Sarawak is a relatively open economy, with its export-to-GDP ratio estimated to be around 93% in 2012, while total trade accounted for an average 124% of nominal GDP in the three years through 2011. More than one-third of its exports in 2011 were liquefied natural gas (LNG) and crude petroleum, while palm oil commanded about 4.1% of total shipments. Meanwhile, saw logs and sawn timber accounted for a combined 1.9% of total exports in the same period. As such, the state's economy is largely dependent on global economic conditions and is vulnerable to movements in commodity prices.

- Sarawak's inflation also moves in line with the national trend, with the growth in consumer price index (CPI) climbing to an average 1.9% y-o-y in 2013, on par with the national level, after rising 1.7% in the preceding year. Notwithstanding this, in the first six months of 2014, the state's inflation rate was higher, averaging at 3.4%, the same trend as in the national CPI. Going forward, we are of the view that the impending introduction of the Goods and Services Tax (GST) in 2Q2015 will likely exert additional pressures on the headline CPI growth, as consumers bring forward their consumption prior to the implementation. Overall, we expect Sarawak's inflation rate to continue its uptrend in tandem with the national rate which we anticipate to climb to 3.5% and 4.4% respectively in 2014 and 2015.

- In 2013, the value of approved manufacturing investment in Sarawak surged by 75% to RM8.3 billion as compared to the RM4.7 billion recorded for the full year of 2012, the third-highest after Johor (RM14.4 billion) and Selangor (RM9.8 billion). The positive trend continued in the first three months of 2014, where the amount of Sarawak's approved manufacturing investment rose to the highest level of RM7.3 billion, constituting about 42.8% of the total manufacturing investment approved in Malaysia. Going forward, the Sarawak Corridor of Renewable Energy (SCORE) project, which involves the development of five key areas in Sarawak by 2030, is expected to be the major growth catalyst for the state for the next 20 to 30 years.

- The Sarawak government's financial position continued to be favourable, posting a remarkable surplus, amounting to an estimated 2.5% of GDP at the end of 2012, slightly lower than previous year's 2.6% of GDP, as the RM560.3 million increase in the state's revenue fell short of the increase in its expenditure, amounting to RM594.6 million. Income from oil and gas-related activities are expected to remain the mainstay of the government's revenue, accounting for an average of 34.5% of state revenue over the past five years. Apart from this, Sarawak's public debt level remained relatively stable at 2.2% of GDP in 2012, the same level as in 2011. Nevertheless, the state government has debt overdue amounting to RM13.0 million in 2012 compared with no arrears in the previous year.

- We are of the view that the main risks to the growth outlook of Sarawak's economy are very much related to the changes in global economic conditions, volatile commodity prices and rising inflationary pressures. Improving global demand will benefit Sarawak's economy, given its openness to international trade. As global demand for key commodities such as crude oil and crude palm oil is becoming more favourable, Sarawak's economy will likely improve in tandem. This is evidenced from the recent uptrend in global oil prices, which hit a 10-month high in June, providing the much-needed boost to Sarawak's economy in the near term. Notwithstanding this, rising inflationary pressures pose a key challenge to the domestic economy going forward, and this could adversely affect Sarawakians' consumption pattern in the near term.

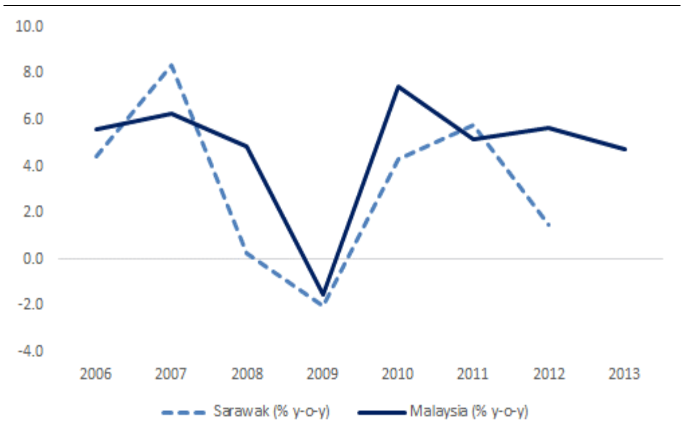
The economy

Sarawak's economy generally moves in tandem with the national trend. However, despite Malaysia's favourable growth performance which accelerated to 5.6% in 2012, Sarawak's real GDP growth unexpectedly slowed to 1.5%, following a 5.8% expansion in the preceding year (Malaysia: 5.2%). Historically, Sarawak's economy is more volatile when compared with the national economy, as evidenced by its standard deviation of 3.5% in the seven years through 2012 (Malaysia: 2.9%). This is mainly due to fluctuations in the output of mining and quarrying, resources that Sarawak is heavily dependent on, with its share of the state's economy more than double the national percentage, at 21.1% in 2012 (Malaysia: 8.4%). Meanwhile, the services sector constituted the largest share of the economy, at 36.8% in 2012, largely attributed to cargo-related activities, air transport and tourism. Manufacturing represented 27.0% of the economic pie, about the same as the national economy (Malaysia: 24.8%) in 2012, while agriculture accounted for a much higher share of 11.6% of the state's output, versus 7.3% of total GDP at the national level. The construction sector, meanwhile, constituted the smallest portion of the economy with a 3.2% share in the same period, parallel with the country level.

The economic slowdown experienced in 2012 was mainly attributed to a severe contraction in the mining and quarrying sector, slumping 7.8% from 2011's 4.4% expansion. In terms of growth contribution, it subtracted 1.8 percentage points from the GDP, as opposed to the 1.0 percentage point contribution in the preceding year. The weak economy was also compounded by a lower contribution from the manufacturing sector which added a mere 0.2 percentage point to the growth in 2012, as compared to an average of 1.3 percentage points in the preceding two years. Notwithstanding this, the services sector remained resilient, growing by a strong 6.4% pace in the same period, and contributing 2.2 percentage points to the overall growth.

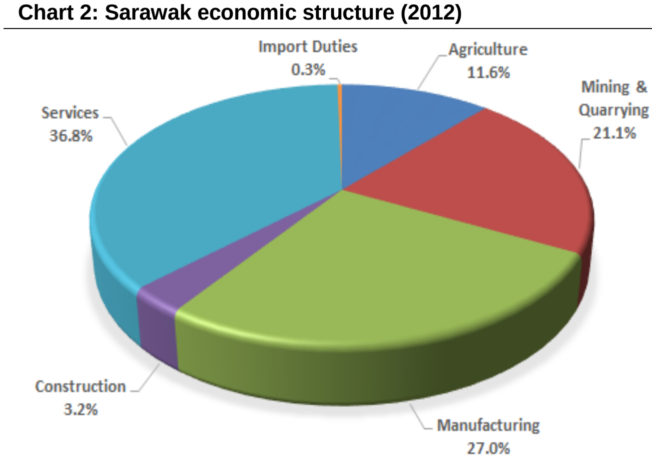
The state's share of national GDP stood at 9.6% in 2012, the third-largest after Selangor (23.5%) and Kuala Lumpur (15.2%). Sarawak is the fourth-most populous state in the country, with a population of 2.62 million in 2013, after Selangor (5.78 million), Johor (3.50 million) and Sabah (3.50 million). GDP per capita was also among the highest in the country, at RM40,414 in 2012, relatively higher than the national level of RM32,084.

Chart 1: Annual GDP Growth



Source: CEIC, MARC Economic Research.

Chart 2: Sarawak economic structure (2012)



Source: CEIC, MARC Economic Research.

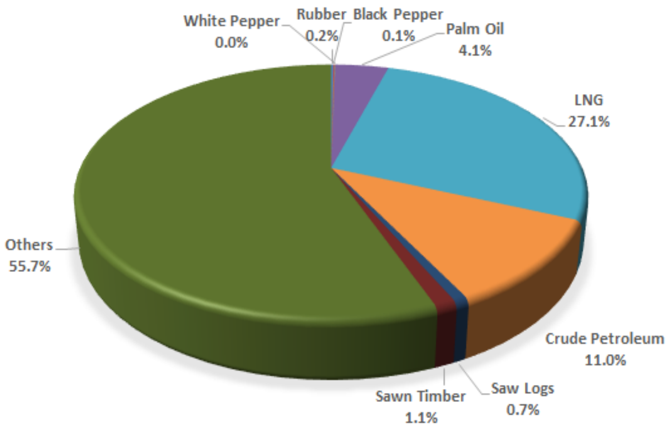
Sarawak is a relatively open economy, with its exports estimated to be around 93% of nominal GDP in 2012, while total trade accounted for an average 124% of nominal GDP in the three years through 2011. More than one-third of its exports in 2011 were LNG and crude petroleum, while palm oil commanded about 4.1% of total shipments. Meanwhile, saw logs and sawn timber accounted for a combined 1.9% of total exports in the same period. As such, the state's economy is largely dependent on global economic conditions and is vulnerable to movements in commodity prices.

Table 1: Sarawak's real GDP growth by sector

Growth (% y-o-y)	2008	2009	2010	2011	2012
GDP	0.3	-2.0	4.3	5.8	1.5
Agriculture	0.9	0.1	3.7	6.0	2.4
Mining & Quarrying	-6.7	-7.7	3.7	4.4	-7.8
Construction	-2.3	7.8	9.9	-1.3	22.5
Manufacturing	-1.6	-5.3	3.6	6.2	0.8
Services	8.0	4.0	5.1	7.1	6.4

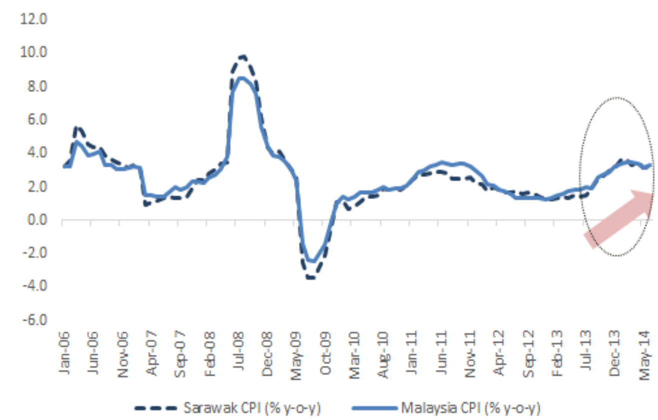
Source: CEIC, MARC Economic Research.

Chart 3: Sarawak's major exports (2011)



Source: Sarawak's EPU, MARC Economic Research.

Chart 4: Sarawak CPI and Malaysia CPI



Source: CEIC, MARC Economic Research.

Inflation

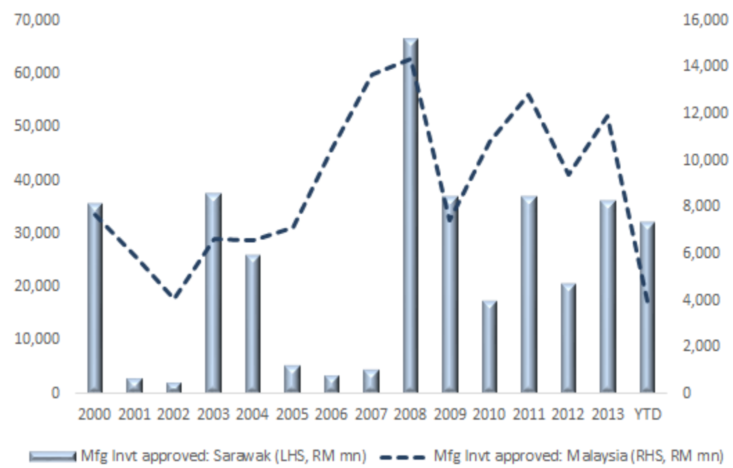
Sarawak's inflation also moves in line with the national trend, with an average CPI growth of 1.9% y-o-y in 2013, on par with the national level, after rising 1.7% the preceding year. However, in the first six months of 2014 the state's inflation rate was higher, averaging at 3.4%, in line with the national CPI. The higher growth was mainly due to an increase in inflationary pressures since 3Q2013 following a few rounds of subsidy rationalisation efforts by the government starting with the fuel price hike in September last year, as well as the removal of the sugar subsidy in October. Subsequently, in 2014, the government revised upward the electricity tariff in January and this was followed by an increase in the price of natural gas for the non-power sector starting in May. Such increases will likely push up the inflation rate in 2H2014. In addition, the impending introduction of GST in 2Q2015 will likely exert more upward pressures on the headline CPI growth, as consumers bring forward their consumption prior to the implementation.

The developments in global commodity prices will also have an important impact on Sarawak's inflationary trend. The recent geopolitical tensions in Ukraine and Iraq have temporarily caused a spike in global oil prices. While this would benefit the Sarawak government in the short term in view of the revenue generated from the oil and gas sector, the increase in consumer prices will impact Sarawakians' consumption especially if the federal government decides to further rationalise its petrol subsidy. Overall, we expect Sarawak's inflation rate to continue its uptrend in tandem with the national rate which we anticipate to climb to 3.5% and 4.4% respectively in 2014 and 2015.

Manufacturing investment approval

Although Malaysia recorded slower economic growth in 2013, the value of approved manufacturing investment in Sarawak surged by 75% to RM8.3 billion as compared to the RM4.7 billion recorded for the full year of 2012, the third-highest after Johor (RM14.4 billion) and Selangor (RM9.8 billion). Meanwhile, in the first three months of 2014, Sarawak registered the highest level of approved manufacturing investment worth RM7.3 billion, constituting about 42.8% of the total manufacturing investment approved in Malaysia. Of this total, about 97% (RM7.1 billion) were from foreign investors, while the remainder were from local investors. The continuation of several infrastructure projects implemented under SCORE contributed to the large investment inflow, outpacing Selangor and Johor which traditionally secured the largest amount of investments resulting from their favourable infrastructure and ecosystem. The SCORE project, which involves the development of five key areas in Sarawak by 2030, is expected to be the major growth catalyst for the state for the next 20 to 30 years, as the government is committed to developing the state to achieve high-income status by the year 2020.

Chart 5: Manufacturing investment approved



Source: MIDA.

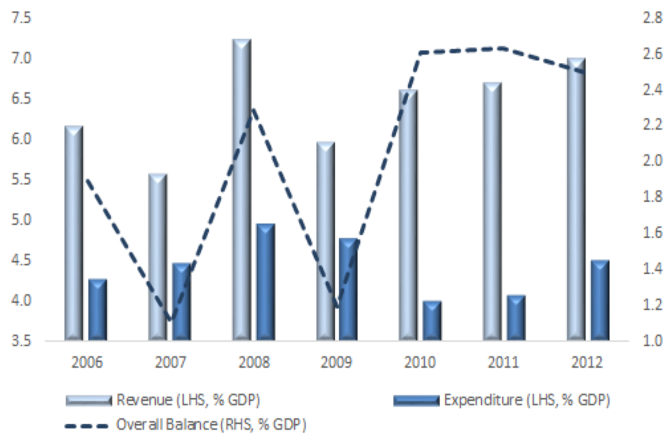
Government finance

The state government's financial position looks solid with a sustained surplus over the six years through 2012. Government revenue rose 8.5% y-o-y to a seven-year high of RM7.2 billion in 2012, from RM6.6 billion in the preceding year. Meanwhile, government expenditure was also on the rise, surging by 14.8% to RM4.6 billion in 2012, after rising 18.7% in the prior period. According to the 2012 Sarawak Auditor General's Report, the increase in revenue was attributed to a 9.1% jump in non-tax receipts due to an increase in investment returns and in the compensation in lieu of gas rights following improvements in production. Key contributors to state revenue for the past five years were dividends, compensation in lieu of oil rights, compensation in lieu of gas rights, forestry royalties as well as receipts and interest income from financial investments, which accounted for a combined 78.7% of state revenue in 2012. On the expenditure side, the increase in spending was broad-based as all categories showed gains from the preceding year, led by a 46.9% jump in the asset category, followed by a 19.0% rise in others payment.

The Sarawak government managed to post a remarkable surplus, amounting to an estimated 2.5% of GDP at the end of 2012, slightly lower than previous year's 2.6% of GDP, as the RM560.3 million increase in revenue fell short of the increase in expenditure amounting to RM594.6 million. Income from oil and gas-related activities is expected to remain the mainstay of the government's revenue, as it represents an average of 34.5% of the state's revenue over the past five years.

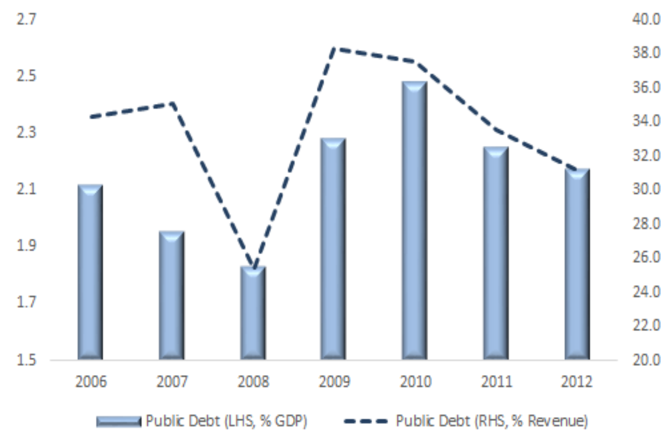
Apart from this, Sarawak's public debt level remained relatively stable at 2.2% of GDP in 2012, the same as in 2011. In terms of value, total liabilities continued to moderate in 2012, rising by a mere 0.6% as compared to a high of 20.4% in 2010, and a 5.7% increase in 2011. Much of this debt is due to continuous support from the federal government especially in the area of development expenditure, with an additional RM95.3 million of new loans received in 2012. The state's contingent liabilities, on the other hand, eased to RM306.7 million from 2011's RM527.0 million. Nonetheless, the state government has debt overdue amounting to RM13.0 million in 2012 compared with no arrears in the preceding year.

Chart 6: State government fiscal position (% GDP)



Source: National Audit Department, MARC Economic Research.

Chart 7: Public debt (% GDP vs % Revenue)



Source: National Audit Department, MARC Economic Research.

Table 2: State government finance

RM million	2008	2009	2010	2011	2012
Revenue	***6,460.7***	***4,563.3***	***5,606.7***	***6,627.1***	***7,187.4***
-Tax Revenue	*1,071.9*	*807.9*	*1,160.1*	*1,252.3*	*1,322.9*
-Non-Tax Revenue	*5,246.0*	*3,642.4*	*4,331.7*	*5,237.3*	*5,714.1*
-Non-Revenue Receipts	*21.6*	*10.4*	*13.0*	*16.4*	*30.7*
-Federal Govt Grant & Loan Repayment	*121.3*	*102.7*	*101.9*	*121.2*	*119.7*
Expenditure	***4,417.9***	***3,647.9***	***3,389.2***	***4,024.2***	***4,618.8***
-Emoluments	*410.2*	*417.1*	*480.8*	*504.5*	*579.4*
-Service & Supply	*421.2*	*487.2*	*473.3*	*525.7*	*533.2*
-Assets	*11.2*	*14.5*	*18.8*	*21.6*	*31.8*
-Grants & Fixed Payments	*352.6*	*368.5*	*311.2*	*382.6*	*393.4*
-Others	*3,222.7*	*2,360.6*	*2,105.1*	*2,589.8*	*3,081.0*
Overall Balance	***2,042.8***	***915.4***	***2,217.6***	***2,603.0***	***2,568.7***
Overall Balance (% GDP)	***2.3***	***1.2***	***2.6***	***2.6***	***2.5***

Source: National Audit Department, MARC Economic Research

Risk factors

- Global economic conditions

  Malaysia's economic growth in 1Q2014 accelerated to 6.2% as compared to the 5.1% expansion registered in the preceding quarter, benefitting from recovery in the external sector. The recent pickup in manufacturing activity in the US and China prove that recovery is underway. Despite some hiccups that were reflected in the US' 1Q2014 growth due to adverse weather conditions, we believe that the economic momentum will continue on its upward trajectory, though at a slower pace than previously expected. For the euro zone, we think that growth prospects will remain decent, supported by the recent policy mix of conventional and unconventional measures unveiled by the European Central Bank in June 2014. In China, meanwhile, stimulus measures by the government to maintain the headline growth above 7.0% per annum paid dividends, as growth accelerated for the first time in three quarters to 7.5% in 2Q2014 from an 18-month low of 7.4% in the prior period. On balance, we foresee Malaysia's economic momentum continuing to post a decent growth of 5.3% in 2014, a pickup from 4.7% in 2013, supported by a significant rebound in the external sector as well as by resilient domestic factors. As the growth trend of Sarawak's economy tends to mimic the national performance, we foresee the overall growth momentum of the state to remain resilient, with a slight improvement towards the second half of this year.

- Commodity prices

  As global demand for key commodities continues to recover, Sarawak's economy will likely improve in the near term. This is evidenced from the recent uptrend in commodity prices especially for crude oil which hit a 10-month high in June 2014, providing some comfort in the near term for a commodity player such as Sarawak. In addition, palm oil prices have consolidated, with the price of the most active futures contracts dwindling to between RM2,300 and RM2,800 per tonne in the recent month, with the latest reading on technical indicators suggesting a lower likelihood of a major correction in the next few months. In addition, the effect of El Nino in recent months will likely result in lower volumes of palm oil production and a rise in the average selling price going forward. With prices expected to remain supportive, Sarawak's economy may not be significantly affected.

- Rising inflationary pressure

  The imposition of GST in April next year will likely push Malaysia's headline inflation to above 4.0% temporarily, although inflation will likely normalize within two years. This is because inflation has been on a rising trend to start with, amidst the federal government subsidy rationalisation efforts since September last year. In addition, prior to the implementation of the GST, consumers would normally bring forward their consumption, exerting additional inflationary pressures towards the year end. As inflation hits the poor the hardest and given the state's relatively skewed income distribution, the impact of higher prices would mean that rural households' balance sheets will continue to be overstretched, thus affecting their future consumption pattern. Going forward, we foresee Sarawak's inflation rate to remain on its upward trajectory mirroring Malaysia's experience.

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