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The State of Sarawak

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In a nutshell

- The state of Sarawak's key strengths are its abundant natural resources which support economic growth, prudent fiscal management and strong liquidity position relative to its debt level, as well as healthy ties with the federal government. The key risk for Sarawak is its high exposure to the vagaries of the global economy as the state is highly dependent on the commodities sector.

- Sarawak's abundant natural resources have continued to drive its economy. Primary sectors such as mining, agriculture and forestry have remained the mainstay of economic output, making up about 32.8% of the economy in 2013 (Malaysia: 15.2%). While Malaysia's economic growth slowed to 4.7% year-on-year (y-o-y) in 2013 (2012: 5.6%), Sarawak's real gross domestic product (GDP) growth accelerated to 4.2% y-o-y (2012: 1.5%) mainly on account of the recovery in the mining and quarrying sector. Additionally, its abundant natural resources have enabled the state to have the second largest of Malaysia's five economic corridors, namely the Sarawak Corridor of Renewable Energy (SCORE). From a medium- to longer-term perspective, MARC is of the view that the economy will benefit from the progress and continuity of investments in major infrastructure projects under SCORE, thereby reducing its heavy reliance on primary-sector exports to drive the economy.

- Sarawak has also benefitted from the state government's prudent fiscal management, as evidenced by its sustained fiscal surpluses over seven years through to 2013. The state government managed to post a remarkable surplus in 2013 amounting to RM2.1 billion, equivalent to its long-term average of 2.0% of GDP (2012: 2.5%), despite a decline in revenue which was mainly due to the 11.4% drop in tax revenue amid lower crude palm oil (CPO) prices as well as lower timber production. The state's financial performance is largely supported by income from oil and gas-related activities which have accounted for an average of 34.8% of the state's revenue over the past five years. However, MARC opines that the slump in global crude oil prices since late 2014 will have some impact on the overall fiscal surplus for 2014 and 2015.

- MARC draws comfort from the state's strong liquidity position, as evidenced by rising liquid assets over the past eight years relative to its public debt level. The state government's consolidated funds, including investment and cash, have risen by a whopping 18.7% per annum (p.a.) on a compound annual growth rate (CAGR) basis in the eight years through to 2013, amounting to RM23.4 billion (2006: RM7.0 billion). As such, MARC believes that the state can comfortably meet its outstanding debt obligations, which in 2013 amounted to RM2.3 billion.

- The state's credit strength is also supported by its good relationship with the federal government. There has been continuous funding support, particularly in the area of development expenditure through grants and loans received which have remained steady over the years. As the current state government has been in place since 1981, we believe the state's political environment will continue to remain stable, thus ensuring policy continuity over the medium term.

- Notwithstanding the positive attributes, MARC takes into consideration Sarawak's high exposure to the vagaries of the global economy, given its position as a key producer and exporter of commodities. The recent downward revisions by the World Trade Organisation (WTO) of its global trade forecast to 3.3% in 2015 from the 4.0% previously predicted suggests rising economic challenges going forward. The slump in global crude oil prices since late 2014 is another concern for the state, as they are now moving towards their lowest levels in five years after a brief rebound in May 2015. On top of that, domestic demand growth in 2015 is expected to decelerate against a backdrop of stronger inflationary pressures in the second half of the year due to the implementation of the Goods and Services Tax (GST), as well as the weakening ringgit.

Key strengths

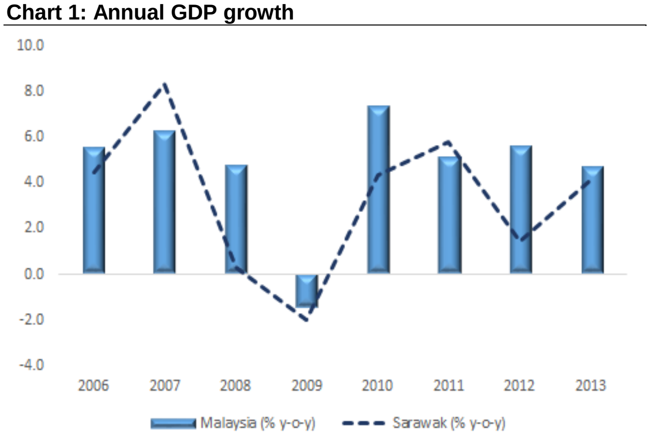
Economic profile and performance

The state of Sarawak continues to benefit from its abundant natural resources, with mining, agriculture and forestry remaining the mainstay of the economy. About one-third of economic output comes from the primary sector; the 21.5% contribution by mining and quarrying activities towards state economic output in 2013 was more than double the sector's portion towards the national GDP (Malaysia: 8.1%). The manufacturing sector made up 26.6% of the economic pie, a tad higher than the country's level of 24.5%, while the construction sector constituted the smallest portion of the economy with a share of 3.1% during the period. The services sector, on the other hand, commanded the biggest share at 37.2% in 2013, up from a low of 29.8% in 2006, largely attributed to higher cargo-related transportation activities, air transport and tourism.

Economic growth in Sarawak is more volatile when compared with economic growth at the national level, mainly due to the gyrations of the commodities sector; in the eight years through to 2013, the standard deviation of Sarawak's GDP growth stood at 3.3%, compared with Malaysia's 2.7%. While Malaysia's economic growth slowed to 4.7% in 2013 (2012: 5.6%), Sarawak's real GDP growth accelerated to 4.2% from 1.5%. The higher economic growth pace in 2013 was mainly driven by the recovery of output in the mining and quarrying sector, which rose 6.1% (2012: -8.0%). In terms of contribution to headline growth, the sector added 1.2 percentage points, compared with -1.9 percentage points in the preceding year. It also helped to offset the relative slowdown of the services sector; in 2013, services-sector output grew by 5.3% (2012: 6.3%) and contributed 1.9 percentage points to GDP, down from an average of 2.2 percentage points in the three years post-Global Financial Crisis (GFC). Meanwhile, manufacturing-sector output picked up pace in 2013, rising by 2.7% from 0.8% in 2012 and adding 0.7 percentage point to headline growth.

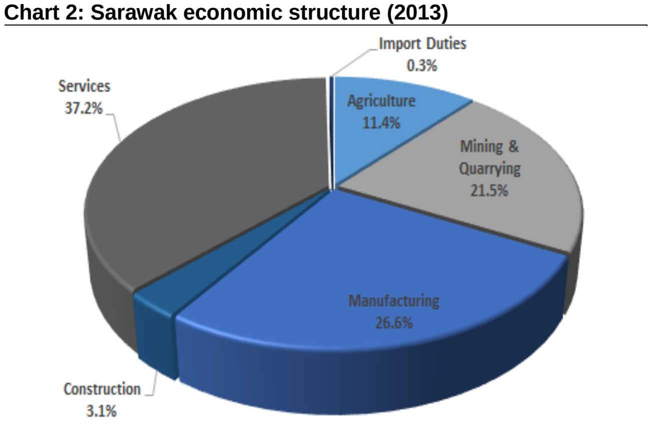
Sarawak is strategically important to Malaysia as the state's share of national GDP in the nine years through to 2013 stood at an average of 10.1%, behind only Selangor (22.2%) and Kuala Lumpur (13.9%). In 2013, Sarawak contributed 0.4 percentage point towards Malaysia's headline growth, the fourth highest contributor after Selangor (1.4 percentage points), Kuala Lumpur (1.0 percentage point) and Johor (0.5 percentage point). Its state per capita income level was also among the highest in the country, ranking number three nationally in 2013 at RM41,115, about 25% higher than the national per capita income level of RM32,984 for the same year.

Chart 1: Annual GDP growth



Source: CEIC, MARC Economic Research

Chart 2: Sarawak economic structure (2013)



Source: CEIC, MARC Economic Research

The Sarawak economy is strongly export-oriented and therefore susceptible to volatile global commodity prices. Total exports as a percentage of state GDP is estimated to have exceeded 100% in 2013, while total trade surpassed 130%. Liquefied natural gas (LNG) accounted for more than half of its exports in 2013, while crude petroleum constituted about 20.8%. As for other exports, only palm oil, saw logs and sawn timber were significant, representing a combined 9.0% of total exports during the same period.

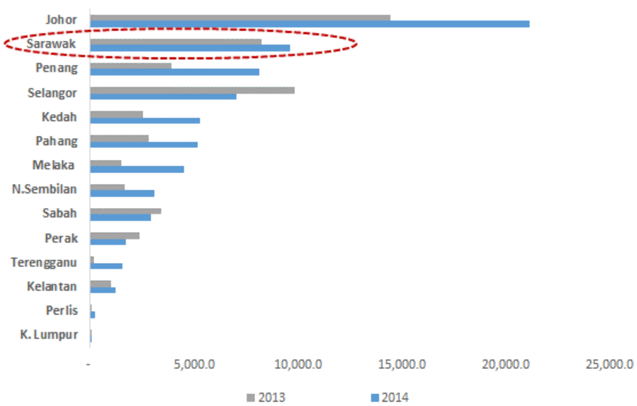
From a medium- to longer-term perspective, MARC is of the view that the implementation of SCORE since 2008 is a credible effort to diversify Sarawak's economy and increase its economic potential. The second largest of the five economic corridors, SCORE has abundant natural resources, including clean and safe renewable resources such as hydropower. Under its 2008-2030 development plan, SCORE will focus on developing the energy sector. It is currently focusing on 10 high-impact major industries that will become major growth catalysts over the longer term to help Sarawak achieve high-income status by 2020. Sarawak has become one of the top investment destinations in Malaysia, attracting total investments of RM9.6 billion in 2014 and taking the second spot from Selangor in terms of value of project investment approved. Of the total, more than 90% went to SCORE, and about 87.2% of total investment approved were from foreign investors.

Table 1: Sarawak's real GDP growth by sector

Growth (%y-o-y)	*2008*	*2009*	*2010*	*2011*	*2012*	*2013*
Real GDP	***0.3***	***-2.0***	***4.3***	***5.8***	***1.5***	***4.2***
- Agriculture	*0.9*	*0.1*	*3.7*	*6.0*	*2.6*	*1.6*
- Mining & Quarrying	*-6.7*	*-7.7*	*3.7*	*4.5*	*-8.0*	*6.1*
- Manufacturing	*-1.6*	*-5.3*	*3.6*	*6.2*	*0.8*	*2.7*
- Construction	*-2.3*	*7.8*	*9.9*	*-1.3*	*22.1*	*1.7*
- Services	*8.0*	*4.0*	*5.1*	*7.2*	*6.3*	*5.3*

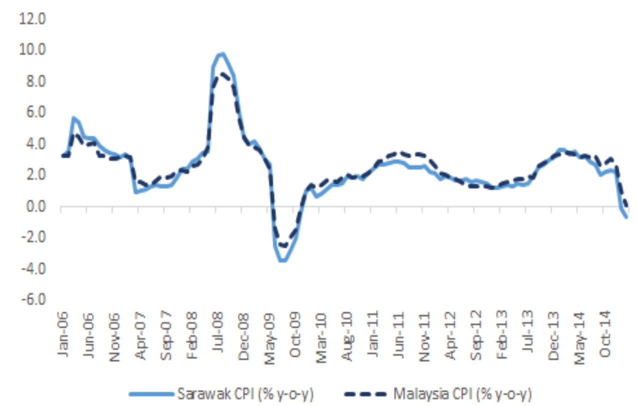
Source: CEIC, MARC Economic Research

Chart 3: Projects awarded by state (RM million)



Source: CEIC, MARC Economic Research

Chart 4: Sarawak and Malaysia inflation trends



Source: CEIC, MARC Economic Research

Inflation

Sarawak's inflationary trend is highly correlated with Malaysia's, and its Consumer Price Index (CPI) growth of 2.9% in 2014 was a shade lower than Malaysia's 3.2%. Indeed, 2014 was a challenging year for Sarawakians as consumer prices rose faster than in the preceding year (2013: 1.9%), mainly due to stronger cost-push factors associated with the several rounds of federal-government subsidy-rationalisation efforts since end-2013. Nevertheless, inflationary pressures started to diminish in the second half of the year (1H2014: 3.4%, 2H2014: 2.4%), partly reflecting the plunge in global crude oil prices since November 2014. This has offered some policy space for the federal government to remove the blanket fuel subsidy system in December 2014, which subsequently led to cuts in pump prices up to February 2015. As a consequence, Malaysia experienced price disinflation during the first six months of 2015, where CPI growth averaged just 1.4% (2H2014: 2.9%). Sarawak's inflation rate slowed to an average of 0.7% during the period, compared with 2.4% in 2H2014.

Notwithstanding the relatively benign inflationary environment, MARC foresees that Sarawak's inflation rate will, just like Malaysia overall, likely remain within the 2.5%-3.0% range in 2015 on account of the implementation of the GST in April 2015. In fact, in the three months since April, inflation has started to accelerate, with CPI growth for Malaysia and Sarawak climbing to 2.2% and 1.5% from 0.7% and -0.2% respectively in the preceding quarter.

State government finances

Sarawak's fiscal management remains prudent, as evidenced by sustained fiscal surpluses over the seven years through to 2013. This is in spite of the marginal decline in government revenue by 0.3% from a year earlier to RM7.16 billion in 2013 (2012: RM7.18 billion). According to the *2013 Sarawak Auditor General's Report*, the decline was mainly due to the 11.4% plunge in tax revenues. CPO prices fell by 20.5% during the year, resulting in a drop in CPO sales tax collection. Lower timber production also contributed to the decline as forestry royalties collected by the state government plunged by 14.9% during the period. Over the past five years, 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 have remained key contributors to state revenue, representing 80% of state revenue in 2013. Despite the revenue shortfall, it is worth noting that accrued revenue surged by 78.8% in 2013 to RM168.53 million, the highest in five years, from RM94.28 million in the preceding year.

On the expenditure side, the state government has shown its commitment to slow the growth of overall outlays in light of the decline in total receipts. Total government expenditure rose 9.0% to RM5.0 billion in 2013, compared with double-digit growth in the preceding two years (2012: +14.8%; 2011: +18.7%). This was on the back of a sharp fall in payments for assets, which plunged 14.3% in 2013 (2012: +46.9%), as well as slower increases in emoluments by 12.5% (2012: +14.9%). These helped offset the 21.7% jump in the grants and fixed payments category.

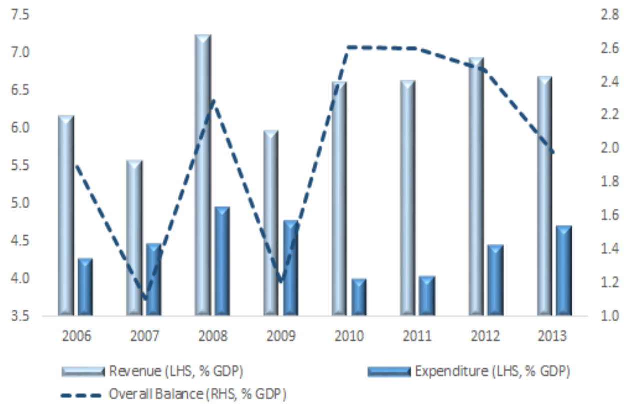
Overall, the Sarawak government managed to post a remarkable, albeit declining, surplus which amounted to RM2.1 billion in 2013 (2012: RM2.6 billion), equivalent to its long-term average of 2.0% of GDP (2012: 2.5%). Income from oil and gas-related activities has contributed about one-third of the state's revenue annually over the past five years and is expected to remain the mainstay of the government's revenue stream going forward. However, following the slump in global crude oil prices since late 2014, MARC is of the view that Sarawak's overall fiscal surplus will be slightly impacted in 2014 and 2015, as they are now moving towards their five-year low registered in the early part of the year, after a brief rebound in May 2015.

Table 2: State government financial performance (RM million)

RM million	*2008*	*2009*	*2010*	*2011*	*2012*	*2013*
Revenue	*6,460.7*	*4,563.3*	*5,606.7*	*6,627.1*	*7,187.4*	*7,163.0*
- Tax Revenue	*1,071.9*	*807.9*	*1,160.1*	*1,252.3*	*1,322.9*	*1,172.7*
- Non-Tax Revenue	*5,246.0*	*3,642.4*	*4,331.7*	*5,237.3*	*5,714.1*	*5,853.1*
- Non-Revenue Receipts	*21.6*	*10.4*	*13.0*	*16.4*	*30.7*	*11.6*
- Federal Govt Grants & Loan Repayments	*121.3*	*102.7*	*101.9*	*121.2*	*119.7*	*125.5*
Expenditure	*4,417.9*	*3,647.9*	*3,389.2*	*4,024.2*	*4,618.8*	*5,036.7*
- Emoluments	*410.2*	*417.1*	*480.8*	*504.5*	*579.4*	*651.9*
- Service & Supply	*421.2*	*487.2*	*473.3*	*525.7*	*533.2*	*560.3*
- Assets	*11.2*	*14.5*	*18.8*	*21.6*	*31.8*	*27.2*
- Grants & Fixed Payments	*352.6*	*368.5*	*311.2*	*382.6*	*393.4*	*478.8*
- Others	*3,222.7*	*2,360.6*	*2,105.1*	*2,589.8*	*3,081.0*	*3,318.5*
Overall Balance	*2,042.8*	*915.4*	*2,217.6*	*2,603.0*	*2,568.7*	*2,126.4*
Overall Balance (%GDP)	***2.3***	***1.2***	***2.6***	***2.6***	***2.5***	***2.0***

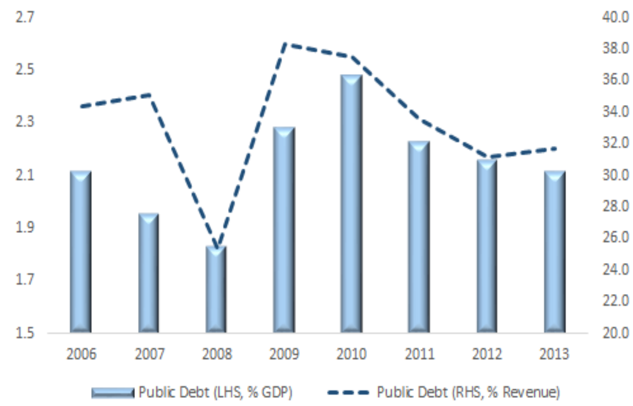
Sources: CEIC, National Audit Department (NAD), MARC Economic Research

Chart 5: Sarawak's government finances



Source: CEIC, NAD, MARC Economic Research

Chart 6: Sarawak's public debt



Source: CEIC, NAD, MARC Economic Research

Low debt level and ample liquidity

All of Sarawak's public debt is obtained from the federal government and on lent to state-owned enterprises and statutory bodies. As the operating surplus has been sufficient to fund its operating and capital expenditure, much of the debt has been used predominantly for development purposes. The state government received an additional RM161.8 million in new loans in 2013 which it used for projects related to water distribution, sanitation and irrigation infrastructure upgrading, industrialisation, as well as farming. Its public debt level has remained broadly stable at 2.1% of GDP in 2013, compared with 2.2% in the preceding year. The state's public debt level, relative to its annual revenue, is low at 31.7% in 2013 (2012: 31.1%), a significant improvement from the high of 38.3% in 2009. In value terms, however, total borrowings increased 1.2% to RM2.3 billion in 2013, marking the highest level in five years, and faster than the 0.6% increase in 2012 (RM2.2 billion). The state's government-guaranteed debt, on the other hand, eased for a second consecutive year to RM98.5 million in 2013 from RM306.7 million previously.

Per the Financial Procedure Act 1957, state governments are allowed to place excess monies from consolidated funds in deposits as well as invest in securities. Sarawak's relatively robust operating and financing surpluses over many consecutive years have led to rising reserve levels, consisting of liquid assets such as cash, fixed deposits and equities. Its consolidated funds, including investment and cash, amounted to RM23.4 billion in 2013, an increase of 18.7% p.a. on a CAGR basis in the eight years through to 2013 (2006: RM7.0 billion). As such, MARC is of the view that Sarawak has ample funds to meet its outstanding debt obligations of RM2.3 billion as of end-2013.

Table 3: Sarawak's consolidated funds

RM million	*2008*	*2009*	*2010*	*2011*	*2012*	*2013*
Consolidated surplus	*6,720.3*	*7,635.7*	*9,853.3*	*12,456.2*	*15,024.9*	*17,151.2*
Consolidated trust funds:	*5,410.6*	*5,596.6*	*5,853.3*	*6,004.2*	*6,071.6*	*6,208.0*
a) Trust funds:						
i) Development funds	*2,911.9*	*2,876.4*	*2,975.6*	*3,183.8*	*3,376.6*	*3,589.7*
ii) Government trust funds	*1,702.9*	*2,022.5*	*1,800.9*	*1,804.6*	*1,897.5*	*1,792.3*
iii) Public trust funds	*230.6*	*250.4*	*267.6*	*239.8*	*216.4*	*204.5*
b) Deposits	*286.6*	*235.8*	*505.1*	*612.5*	*367.2*	*452.4*
c) Payables	*278.7*	*211.6*	*304.2*	*163.5*	*214.0*	*169.1*
Total	***12,130.9***	***13,232.2***	***15,706.6***	***18,460.4***	***21,096.5***	***23,359.2***

Source: NAD

Healthy ties with the federal government

Sarawak's good relationship with the federal government, as evidenced by continuous funding support (particularly in the area of development expenditure through grants and loans received) which have remained steady over the years, is a credit strength. As the current state government has been in place since 1981, the state's political environment is expected to remain stable, thus ensuring policy continuity over the medium term.

Risk factors

Global economic conditions

While Malaysia has registered a respectable economic growth rate of 5.6% in 1Q2015 (4Q2014: 5.7%), we opine that overall GDP growth will moderate for the rest of 2015. This will be on the back of decelerating domestic demand growth, particularly private consumption and investment, as well as moderating export performance due to weaker global trade against a backdrop of uncertainty in the major economies – specifically Europe, China and Japan. In its latest *World Economic Outlook update (July 2015)*, the International Monetary Fund (IMF) reiterated its view that global growth will remain moderate following the divergence in growth prospects between the advanced and emerging economies. It expects the global economy to expand 3.3% in 2015, slightly lower than the 3.4% growth registered in the preceding year, before picking up to 3.8% in 2016. In addition, the WTO in April 2015 lowered its global trade growth projection for the second time to 3.3% in 2015 (2014: 2.8%), down from its previous projection of 4.0%, mainly on expectations of sluggish global economic growth.

We reiterate our view that the Malaysian economy will remain resilient in the medium term, although real GDP growth will decelerate to 4.7% in 2015 from 6.0% in the preceding year. As Sarawak's economy tends to mimic national GDP performance, we foresee the state's overall growth momentum to also weaken slightly in the near future; this is also on account of it being strongly export-oriented. Over the medium term, however, the economy will continue to benefit from the progress and continuity of investments under the SCORE initiative.

Commodity prices

Sarawak's economy will likely be impacted by the recent rout in the global commodity market due to its high dependency on the sector, particularly in oil and gas as well as palm oil. Although global crude oil prices have rebounded by more than 40% in May from its trough in January 2015, it appears that the momentum was short-lived, as it is now moving back towards the low level recorded in January amid renewed concerns over a supply glut in the market resulting from the anticipation of higher production from Iran as well as the downside risks emanating from the Chinese economy. The Brent crude oil price, for instance, is a far cry from its five-year average of USD102 per barrel, being 50% lower than 2014's average of USD99.45 per barrel. Nonetheless, we are of the view that the current oil price levels are not sustainable for a prolonged period, although downside risks to this outlook remain. Similarly, CPO futures remain under pressure with prices plunging to an 11-month low in early August 2015, undermined by weak import prospects from China and India as well as a record-high soybean harvest. As such, we anticipate CPO prices to remain sluggish and will not likely exceed RM2,400 per tonne over the near term.

Rising inflationary pressures

Although generally declining oil prices have provided some relief from inflationary pressures, the implementation of GST in April 2015 will likely push Malaysia's headline inflation to above 3.0% temporarily before moderating in the next 12 months or so. Additionally, the recent weakness of the ringgit will exert upward pressure on inflation due to higher costs of imported items. As inflation hits the poor the hardest, and given the state's relatively skewed income distribution, higher consumer prices would conceivably stretch the balance sheets of rural households, thus affecting their future consumption patterns. Going forward, we expect Sarawak's inflation rate to ascend, mirroring Malaysia's.

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