Economic Research

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The State of Sarawak

MALAYSIAN RATING CORPORATION BERHAD
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Economics Team

Nor Zahidi Alias
Chief Economist
+603 2082 2200
zahidi@marc.com.my

Mohd Afzanizam Abd Rashid
Economist
+603 2082 2200
afzanizam@marc.com.my

James Foo Kok Chye
Economic Analyst
+603 2082 2200
jamesfoo@marc.com.my

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In a nutshell

- The economy is estimated to have grown by 5.4% in 2010 after having experienced a contraction of 1.4% in 2009. According to state officials, this growth was attributed to several major infrastructure projects implemented under the Sarawak Corridor of Renewable Energy (SCORE) as well as the robust services sector and strong commodity prices.

- Thus far, economic indicators have generally been positive. For example, manufacturing investment approvals have improved to RM5.0 billion between January and July this year, compared with RM3.9 billion for the full year of 2010. This heartening development suggests that investment trends are likely to spearhead economic activities, and should translate into sustained gross domestic product (GDP) growth in 2011 and in 2012.

- Another positive development is that the relatively high commodity prices, such as those of crude palm oil (CPO), crude oil and gas as well as timber products, indicate that Sarawak will stand to benefit from favourable terms of trade. Demand for saw-logs has been favourable, with exports to key countries such as India and Japan registering double-digit growth rates of 92.3% year-on-year (May: 6.7%) and 65.7% (May: 6.4%) respectively in June this year.

- The government's financial position is generally healthy with a sustained surplus of RM3.3 billion (or 4.4% of GDP) in 2009, which is albeit lower than the preceding year's RM6.5 billion (7.4% of GDP). The state's financial position is favourable with a sustained surplus and only a minimum level of debt of just 2.4% of GDP. Income from oil & gas-related activities, accounting for more than 40% of the state's government revenue, are expected to remain the mainstay of the government's revenue stream. The fall in 2009's oil revenue should not cause undue concern, given that it was a recessionary year which corresponds with lower oil prices.

- Apart from that, the state government's healthy ties with the Federal Government suggest continuous funding support, especially in the area of development expenditure. Indeed, this has been evidenced by federal government grants and loan repayments remaining steady over the years. On that score, we think that the state of Sarawak's government finances will likely remain in good condition in the near future.

- On a negative side, rising inflation can potentially affect the strength of Sarawakians' purchasing power and translate into moderate or cautious consumer spending in the state. This is particularly true when food prices are expected to remain elevated in the near term. Additionally, with the current open nature of Sarawak's economy (total trade stands at 1.4 times of state GDP), the state is vulnerable to changing dynamics in trade patterns on account of the headwinds emanating from the West.

- The major risk factors, in our opinion, are related to global economic conditions, given the openness of the state's economy. Rising risk aversion may affect the global investment climate if uncertainties resulting from the turmoil in several European economies persist. Should this lead to declining trade activities and lower commodity prices, there will be downward pressure on economic activity and the state government's coffers. The good news, however, is that the recent slew of heartening economic developments in the United States suggests that the worst-case scenario of another meltdown in the global economy might not materialise.

- Political concerns have emerged following stronger opposition influence after the latest state elections on 16 April 2011 which saw the opposition gaining some political ground. It is thus of paramount importance that the present administration ensures the continuity of the state's economic success story to gain further support from the electorate. On a brighter note, the relationship between the state and the federal government will not likely be affected even with the bigger presence of the opposition as the state needs to continuously project a good image to foreign investors who have been pouring their investments into Sarawak.

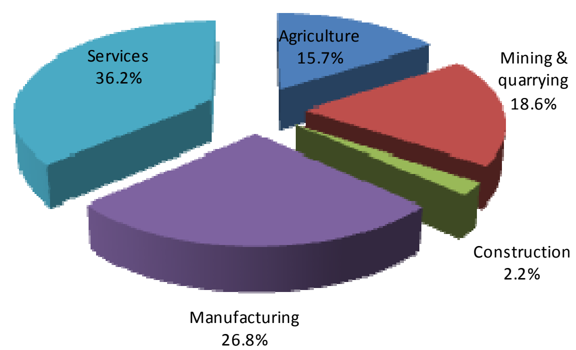
The economy

The Sarawak economy's share of national gross domestic product (GDP) stands at 9.4%, the third largest in Malaysia after Selangor (22.1%) and Kuala Lumpur (14.8%). The state is also one of the most populous states in the country, with its population amounting to 2.47 million in 2010, the fourth largest after Selangor (5.46 million), Johor (3.35 million) and Sabah (3.21 million). Meanwhile, income per capita is one of the highest in the country, with GDP per capita at RM30,318 in 2009 - notably higher than the national level of RM24,366. The state is also blessed with natural resources and minerals aplenty, such as petroleum, gas, coal, silica sand and kaolin clay, with approximate reserves of 1,388 million per barrels, 42.6 trillion standard cubic feet (SCF), 1,483 million tonnes, 73.8 million tonnes and 22.6 million tonnes respectively.

In terms of the economic pie, the services sector accounted for 36.2% of the state's total output in 2009, the most amongst sectors. Cargo-related activities, air transport as well as tourism are the few significantly contributing constituents of the services sector. The manufacturing sector, in comparison, commands 26.8% of total GDP with activities generally associated with export-oriented industries. Major export products in 2009 include liquefied natural gas (LNG) (RM31.2 billion), crude petroleum (RM13.8 billion), palm oil (RM4.6 billion) and saw logs (RM1.8 billion). Apart from that, mining and quarrying as well as agriculture accounted for 18.6% and 15.7% respectively, while construction is the smallest sector that constitutes just 2.2% of GDP.

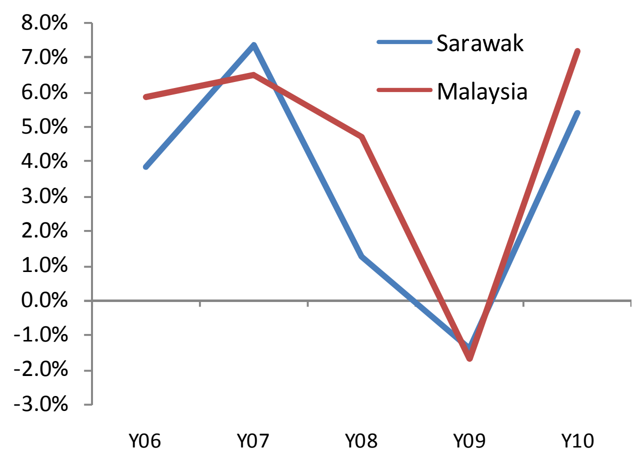
The economy is estimated to have grown by 5.4% in 2010 after having experienced a contraction of 1.4% in 2009. According to state officials, this growth was attributed to several major infrastructure projects implemented under SCORE as well as the robust services sector and strong commodity prices. The SCORE project will involve the development of a vast area spanning 230 kilometres within the five key areas in Sarawak by 2030, as the government is committed to developing the state to achieve high-income status by the year 2020.

Chart 1: Sarawak's 2009 GDP breakdown



Source: CEIC

Chart 2: GDP growth of Sarawak and Malaysia (%)



Source: CEIC

Thus far, economic indicators have generally been positive. For example, manufacturing investment approvals have improved to RM5.0 billion between January and July this year, compared with RM3.9 billion for the full year of 2010. This heartening development suggests that investment trends are likely to spearhead economic activities, and should translate into sustained GDP growth in 2011 and 2012. Moreover, higher commodity prices (such as those of palm oil, crude oil and gas as well as timber products) indicate that Sarawak will stand to benefit from favourable terms of trade. Demand for saw-logs has been favorable, with exports to key countries such as India and Japan registering double-digit growth rates of 92.3% year-on-year (May: 6.7%) and 65.7% (May:6.4%) in June this year respectively. Strong growth in India as well as the ongoing reconstruction activities in Japan portends healthy demand from these countries going forward, at least in the near term.

Nonetheless, rising inflation can potentially affect the strength of Sarawakians' purchasing power and translate into moderate or cautious consumer spending in the state. This is particularly true when food prices are expected to remain elevated in the near term. The latest consumer price index (CPI) reading for Sarawak showed that inflation was sustained at between 2.8% and 2.9% between April and July this year, compared with 2.4% in January 2011. The higher CPI was attributed to increases in the "food & non-alcoholic beverages" as well as "transport" sub-indices during the year. Looking at the international trade for food in Sarawak, it appears that the state has continued to register a trade deficit of RM2.1 billion in 2009, a marked increase from RM1.6 billion in 2007, implying significant susceptibility to international food prices given the state's need to import foodstuff to meet local demand.

Additionally, with the current open nature of Sarawak's economy (total trade stands at 1.4 times of state GDP), the state is also vulnerable to changing dynamics in trade patterns on account of the headwinds emanating from the West. Hence, economic growth in 2011 is expected to be in the range of 3.0% to 3.5% amidst the uncertainty in the external economy.

Table 1: Sarawak's GDP growth

	2006	2007	2008	2009	2010*
GDP	3.8%	7.4%	1.3%	-1.4%	5.4%
Agriculture	-3.1%	2.3%	1.0%	0.6%	5.2%
Mining & quarrying	3.8%	9.2%	-6.2%	-4.5%	3.2%
Construction	1.1%	16.5%	-2.2%	4.2%	6.5%
Manufacturing	9.0%	4.6%	-0.9%	-5.9%	4.5%
Services	3.2%	10.6%	8.0%	2.9%	7.2%

Sources: CEIC and Chief Minister's Website
Note: * = estimates by state officials

Government finances

The government's financial position is generally healthy with a sustained surplus of RM3.3 billion (or 4.4% of GDP) in 2009, which is albeit lower than the preceding year's RM6.5 billion (7.4% of GDP). This outcome was largely attributed to a decline in revenue collection in 2009, led by the sharp 31% fall in non-tax revenue. According to the *2009 Auditor-General's Report Malaysia*, key items which underpinned the decline in revenue were dividends (-62.7%), compensation in lieu of oil rights (-32.4%), forestry royalty (-35.2%), crude palm oil (-22.7%) and office buildings (-74.1%). On the expenditure side, total outlays were relatively stable with a total of RM1.3 billion spent in 2009 against the RM1.2 billion incurred in the preceding year.

Overall, the state's financial position is favorable with a sustained surplus and only a minimum level of debt (at just 2.4% of GDP). Income from oil & gas-related activities, accounting for more than 40% of the state's government revenue, are expected to remain the mainstay of the government's revenue stream. The fall in 2009's oil revenue should not cause undue concern, given that it was a recessionary year which corresponds with lower oil prices. The International Monetary Fund (IMF), in its latest *World Economic Outlook 2011* released in October, projected oil prices to be in the range of USD103 per barrel in 2011 and USD100 per barrel in 2012, markedly higher than the USD62 per barrel level recorded in 2009 and USD79 per barrel in 2010.

Apart from that, the state government's healthy ties with the Federal Government suggest continuous funding support, especially in the area of development expenditure. Indeed, this has been evidenced by federal government grants and loan repayments remaining steady over the years. Additionally, the latest national Budget 2012 revealed several spending allocations which directly affect Sarawak's economy, and these are RM1.1 billion for the provision of electricity supply in the rural areas (particularly in Sabah and Sarawak), and RM52 million for the provision of water tanks to be used for rainwater harvesting. Therefore, the state of Sarawak's government finances will likely remain in good condition in the near future.

Table 2: State government finances (RM billion)

	2005	2006	2007	2008	2009
Revenue	**3,229.0**	**3,973.5**	**4,055.4**	**6,460.7**	**4,563.3**
-Tax Revenue	939.4	900.8	993.8	1,071.9	807.9
-Non-Tax Revenue	2,178.6	2,961.1	2,950.8	5,246.0	3,642.4
-Non-Revenue Receipts	23.0	21.7	16.1	21.6	10.4
-Federal Govt Grant & Loan Repayment	88.0	89.9	94.7	121.3	102.7
Expenditure	**1,127.4**	**1,126.3**	**1,116.2**	**1,217.9**	**1,297.9**
-Emoluments	318.3	336.9	362.3	410.2	417.1
-Service & Supply	413.1	412.3	419.6	421.2	487.2
-Assets	21.7	15.5	10.1	11.2	14.5
-Grants & Fixed Payments	372.6	359.4	322.4	352.6	368.5
-Others	1.8	2.2	1.7	22.7	10.6
Overall balance	**2,101.7**	**2,847.3**	**2,939.2**	**5,242.8**	**3,265.4**
Overall balance % of GDP	**4.1%**	**4.7%**	**4.5%**	**7.4%**	**4.4%**
State government debt to GDP	**2.7%**	**2.3%**	**2.2%**	**2.3%**	**2.4%**

Sources: CEIC and National Audit Department

Risk factors

- **Global economic conditions**

Given its openness to international trade, the state's economy will likely experience a slowdown should global economic activity continue languishing at the prevailing low levels. Indeed, with global economic growth envisaged to moderate from 5.1% in 2010 to an estimated 4.0% in 2011 and 2012 respectively, (according to IMF forecasts), we foresee that the overall trade performance for the state and even for Malaysia will moderate to a single-digit growth rate. Notwithstanding this, the recent slew of heartening economic developments in the United States, such as the higher-than-expected 3Q2011 GDP growth of 2.5%, the smallest number of people continuing to claim unemployment benefits, and the stable Institute for Supply Management (ISM) new orders index together ignite hopes that the worst-case scenario of another meltdown in the global economy might just not materialise. Besides, the agreement by European policymakers to boost the size of the region's rescue fund to one trillion euros has birthed hopes that a resolution to the long-standing crisis can be found in the near term.

- **Sustained commodity prices**

The upside risk is that although the world economy is softening, demand for commodities has demonstrated commendable resilience in the face of debilitating headwinds from the western world. This is primarily due to the fact that China, the world's second-largest economy, is still expected to expand at above 9% in the next year. In addition, India will also see its growth registering in the range of 7% to 8% in the next few years. With the US economy expected to find its footing and the eurozone's conditions not likely to lead to a collapse of European powerhouse economies such as Germany and France, commodity prices will likely remain relatively strong in the near term. Oil prices are expected to be in the range of $80 to $100 per barrel, according to the International Energy Agency (IEA), while CPO prices are projected to be in the region of RM3,000 per tonne. With prices anticipated to remain firm next year, Sarawak's economic activity will not be significantly affected.

- **Political risks**

The latest state elections on 16 April 2011 revealed that although the ruling Barisan National-led coalition managed to retain a two-thirds majority, the opposition has managed to gain some ground, especially the Democratic Action Party (DAP) which secured more seats in this recent election compared with the previous election. It is thus of paramount importance that the present administration ensures the continuity of the state's economic success story to gain further support from the electorate. On a brighter note, the relationship between the state and the federal government will not likely be affected even with the bigger presence of the opposition party as the state needs to continuously project a good image to foreign investors who have been pouring their investments into Sarawak.

- **Inflation**

The state's high dependency on international food supplies makes it rather vulnerable to gyrations in commodity prices, which can ultimately impact on private consumption in the state. Already, higher living costs are exerting downward pressure on household spending, but the rising income inequality adds another dimension to the equation that policymakers would need to solve. Indeed, the state's Gini coefficient (a commonly used measure of the inequality of a distribution; a value of 0 expressing total equality, while 1 connotes absolute inequality of income) rose from 0.440 in 2004 to 0.448 in 2009, according to the *2009 Household Income Survey*.

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MALAYSIAN RATING CORPORATION BERHAD (Company No.: 364803-V)
5th Floor, Bangunan Malaysian Re, No. 17, Lorong Dungun, Damansara Heights, 50490 KUALA LUMPUR
Tel.: +603 2082 2200 Fax: +603 2094 9397 E-mail: marc@marc.com.my
Homepage: www.marc.com.my