

# Economic Research

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## *The State of Sabah*



**MALAYSIAN RATING CORPORATION BERHAD**  
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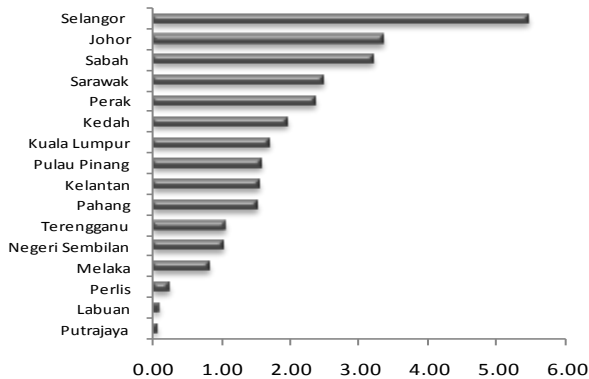
## In a nutshell

- In terms of employment, Sabah's economic activities were predominantly in the primary sector, namely the timber industry. Although the role of the agriculture sector has declined in recent years, it continued to command an approximately 23% of total gross domestic product (GDP) in 2010. Palm oil, rubber and cocoa were the key crops grown on Sabah soil. The services sector, on the other hand, continues to gain importance with its share of GDP rising to 50.4% in 2010 from 47.9% in 2005.
- The tourism subsector is an important growth driver, given the many tourist attractions in Sabah. Indeed, for the first nine months of this year, the number of tourist arrivals grew strongly by 14.5% compared with the full-year growth rate of 11.5% in 2010. However, the growth in the number of foreign tourists plunged to 3.4% from 41.6% within the first three quarters as the number of tourists from the European and North American continents decreased considerably due to a dramatic reduction in consumer spending as a result of unfavourable economic conditions.
- The rising importance of the oil and gas sector is very much related to the commencement of oil production in the Kikeh oil field in 2007, leading to a spectacular growth of 85.4% in 2008 (2007: 18.3%). The outlook for this sector is promising, especially when a number of new oilfields were discovered, opening the doors for further commercialisation of the oilfields in the near term.
- The state's GDP expanded 2.4% in 2010, moderating from 3.8% and 7.3% in 2009 and 2008 respectively. For many years, GDP growth performance has not been in tandem with the national growth trend, possibly due to the weaker influence of the external sector on the domestic economy. For 2011, the state government envisaged that the state's GDP growth will be in the region of 6.0% to 6.5%, a level which we think is achievable due to strong commodity prices throughout the year.
- The state is ranked in the lower quartile of the economic development scale with GDP per capita of RM17,242 in 2010, markedly lower than the national level of RM27,113. Apart from that, the state's poverty level is the highest in the country at 4.7% while income disparity has increased, as evidenced by the Gini coefficient which rose to 0.453 in 2009 compared with 0.450 in 2007.
- The state's finances have generally been favourable with a RM730.3 million surplus registered in 2010, higher than the RM186.6 million surplus recorded in the preceding year. Commodities such as crude palm oil (CPO) and crude petroleum were the main contributors to state government revenue in the form of sales tax and royalties.
- Despite Sabah's favourable financial standing in 2010, the state's public debt was rising at a rapid clip of 30.6% in 2010, owing to bond issuances amounting to RM544 million as well as new loans granted by the federal government totalling RM168 million during the year. As a result, public debt stock as a percentage of total revenue remained elevated at 73.9% in 2010 (2009: 77.9%). Higher borrowings by the state are undertaken for the purpose of funding major economic development projects such as water supplies and low-cost housing.
- Some of the risk factors associated with Sabah's economy include the gyrations in international commodity prices which will evidently have direct implications on the government's revenue stream, the incidence of poverty and rising income disparity which, if left unattended, could breed resentment among Sabahans and the rapid increases in the state's debt level may compromise the state government's debt-servicing ability, especially when the pace of debt increases has surpassed revenue growth.

## Introduction

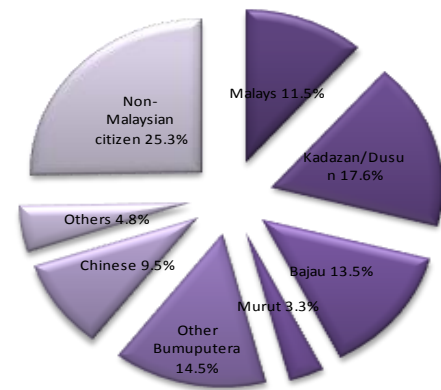
Sabah is one of Malaysia’s member states and is located to the northern region of Borneo Island. The state is deemed to be the second largest in the country after Sarawak, which it borders on its southwest. Sabah also shares borders with the province of East Kalimantan of Indonesia. The population of Sabah was 3.21 million in 2010 and it is the third most populous state in Malaysia after Selangor (5.46 million) and Johor (3.35 million). Based on the population census conducted in 2000, Kadazan/Dusun was the largest ethnic group, constituting 17.6% of the total population, followed by Bajau (13.5%), Malays (11.5%), Chinese (9.5%) and Murut (3.3%).

**Chart 1: Midyear population in 2010 (million)**



Source: CEIC

**Chart 2: Ethnic composition in Sabah (2008)**



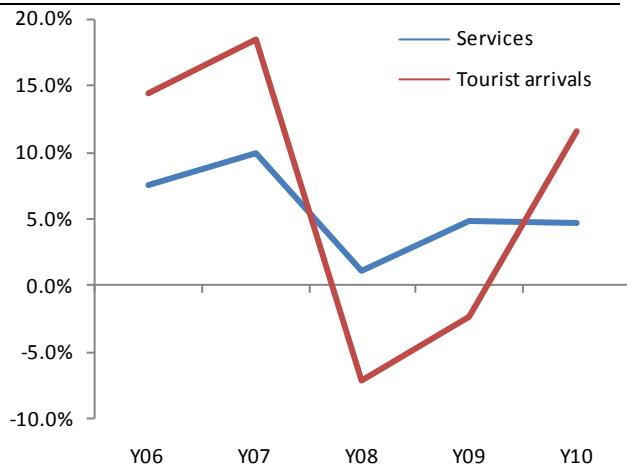
Source: Department of Statistics (DOS)

## The economy

In terms of employment, the state’s economic activities were predominantly in the primary sector, namely the timber industry. However, the timber industry has also brought about severe depletion of precious tropical rainforest resources over the years, leading to concerted efforts to conserve the remaining rainforests to restore ecological imbalances. Despite the declining role of the agricultural sector, it continued to command an approximately 23% of total GDP in 2010. Palm oil, rubber and cocoa were the key crops grown on Sabah soil. Given this scenario, it comes as no surprise that most Sabahans are employed in the agricultural sector. The services sector, on the other hand, continues to gain importance with its share of GDP rising to 50.4% in 2010 from 47.9% in 2005.

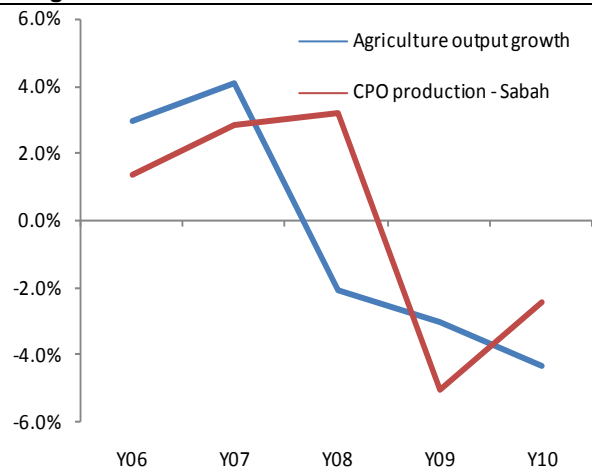
Within the services sector, the tourism subsector is an important growth driver given the many tourist attractions in Sabah, including Mount Kinabalu and the coastal parts of Pulau Sipadan. The importance of the tourism subsector is manifested in the strong correlation between the growth in tourist arrivals and the overall performance of the services sector between 2005 and 2010 (correlation of 88%). Indeed, for the first nine months of this year, the number of tourist arrivals grew strongly by 14.5% compared with the full-year growth rate of 11.5% in 2010. However, the growth in the number of foreign tourists plunged to 3.4% from 41.6% within the first three quarters as the number of tourists from the European and North American continents fell by 26% and 3% respectively due to a dramatic reduction in consumer spending as a result of unstable labour-market conditions and business sentiments following the prevailing unfavourable economic conditions.

Chart 3: Services sector growth vs. tourist arrival growth



Source: CEIC

Chart 4: Agricultural sector growth vs. CPO production growth



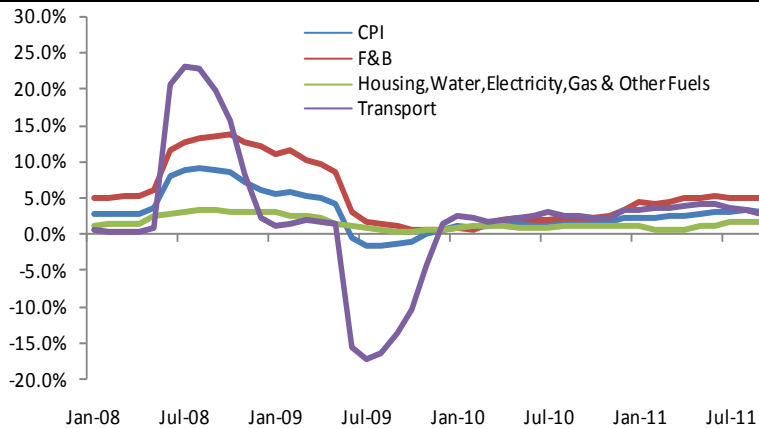
Source: CEIC

The oil and gas sector (categorised as mining and quarrying in the national accounts) constitutes a fairly sizeable share of GDP (2010: 16.9%; 2009: 16.5%). The rising importance of this sector is very much related to the commencement of oil production in the Kikeh oil field in 2007, leading to a spectacular growth of 85.4% in 2008 (2007: 18.3%). The outlook for this sector is promising, especially when a number of new oilfields were discovered, opening the doors for further commercialisation of the oilfields in the near term. According to recent news flow, Petronas Carigali Sdn Bhd has discovered a new oilfield 100 kilometres off the northwest coast of Sabah, with preliminary estimates suggesting that the amount of oil reserves will be in the region of 227 million barrels. Meanwhile, production tests in three different reservoirs yielded a maximum production rate of 8,200 barrels a day.

The state's GDP expanded 2.4% in 2010, moderating from 3.8% and 7.3% in 2009 and 2008 respectively. For many years, GDP growth performance has not been in tandem with the national growth trend, possibly due to the weaker influence of the external sector on the domestic economy. Notwithstanding this, Sabah's economy is still subject to some external forces given that its main export items consist of CPO and crude petroleum where prices are generally determined by international market forces.

Based on the Budget 2011 speech, the state government envisaged that the state's GDP growth will be in the region of 6.0% to 6.5% in 2011, a level which we think is achievable due to strong commodity prices throughout the year. On the inflation front, consumer prices have generally been on the rise, with the consumer price index (CPI) continuing its upward trend to hit 3.3% in September this year from 2.4% in January. The increase came largely on the back of higher prices of food and non-alcoholic beverages which grew by 4.8% during the month.

**Chart 5: CPI and its components (y-o-y%)**



Source: CEIC

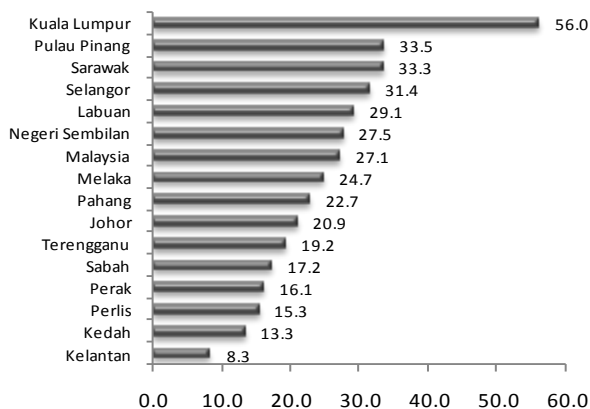
**Table 1: GDP growth**

Growth	Y06	Y07	Y08	Y09	Y10
GDP	5.4%	3.9%	7.3%	3.8%	2.4%
Agriculture	3.0%	4.1%	-2.1%	-3.0%	-4.3%
Mining & Quarrying	2.9%	-18.3%	85.4%	20.4%	4.3%
Construction	8.6%	-25.9%	-2.8%	5.0%	3.9%
Manufacturing	3.2%	2.0%	2.4%	-8.3%	4.4%
Services	7.7%	10.0%	1.0%	4.8%	4.6%

Source: CEIC

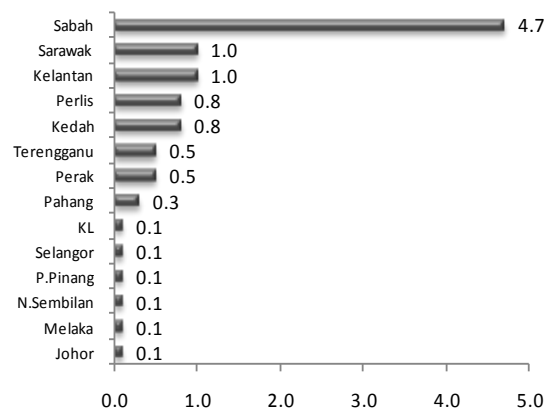
In terms of economic development, the state is ranked in the lower quartile with GDP per capita of RM17,242 in 2010, markedly lower than the national level of RM27,113. Apart from that, the state's poverty level is the highest in the country at 4.7% while income disparity has increased, as evidenced by the Gini coefficient which rose to 0.453 in 2009 compared with 0.450 in 2007. Against this backdrop, we opine that speedy economic development through public spending as well as foreign direct investment are keys to sustainable economic growth for the state in the next few years.

**Chart 6: GDP per capita in 2010 (RM thousand)**



Source: CEIC

**Chart 7: Incidence of hardcore poverty in 2009 (%)**

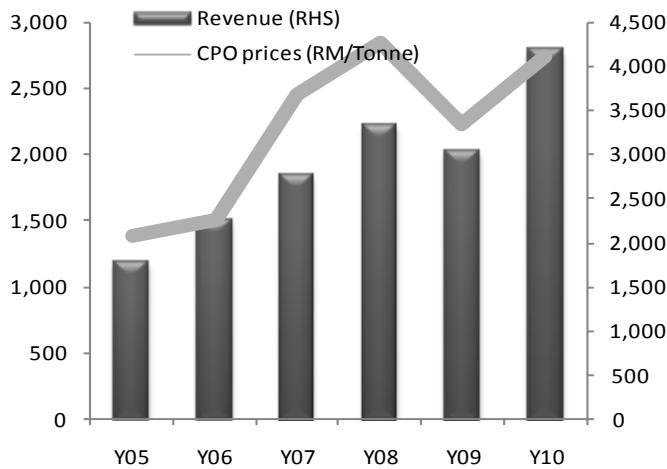


Source: Household Income Survey (HIS) 2009

## Government finances

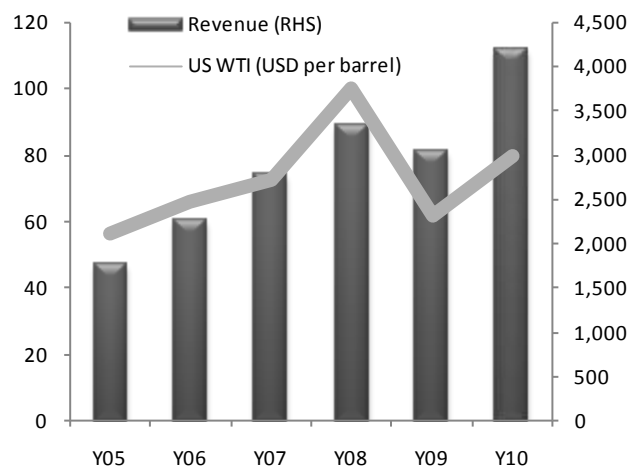
The state's finances have generally been favourable with a RM730.3 million surplus registered in 2010 higher than the RM186.6 million surplus recorded in the preceding year. The surplus balance registered in 2010 came on the back of revenue collection that was 37.7% higher than 2009. Commodities such as CPO and crude petroleum were the main contributors to state government revenue in the form of sales tax and royalties. It is worth noting that these two main revenue generators constitute, on average, slightly more than 50% of total revenue in the past five years. According to the latest audit report, sales tax on CPO surged 25.7% to RM1.1 billion following stronger CPO prices which averaged at RM2,707 per tonne in 2010, compared with RM2,210 per tonne in the prior year. In the same vein, petroleum royalties increased by 11.2% in 2010 to RM826.6 million as the royalty payment benefited from higher average oil prices of RM254 per barrel compared with RM247 per barrel in the preceding year. This was followed by land premium collection which jumped by 153.2% in 2010 to RM222.3 million as the government was able to collect premiums that were previously in arrears.

**Chart 8: Sabah state government revenue (RM million) vs. CPO prices**



Source: CEIC

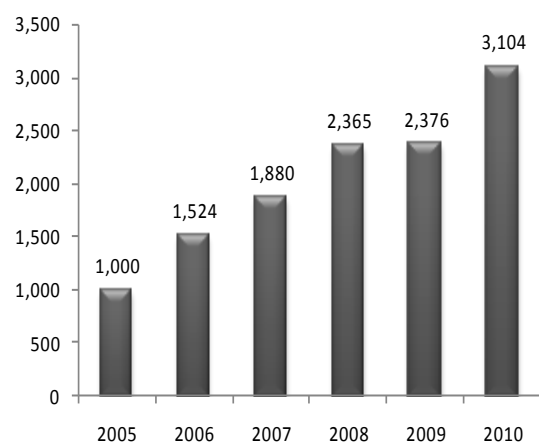
**Chart 9: Sabah state government revenue (RM million) vs. crude oil prices**



Source: CEIC

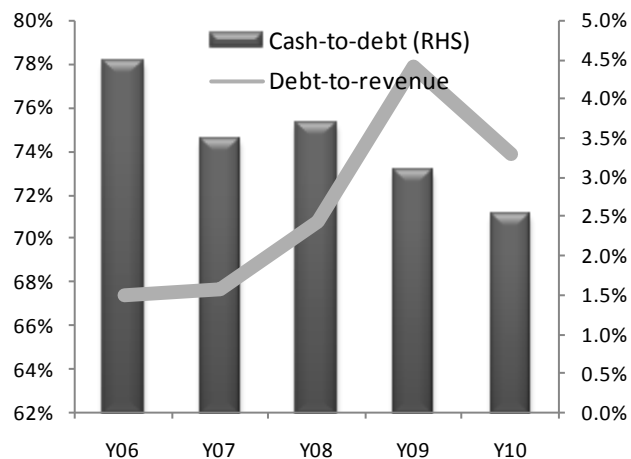
Despite Sabah's favourable financial standing in 2010, the state's public debt was rising at a faster clip of 30.6% in 2010, owing to bond issuances amounting to RM544 million as well as new loans granted by the federal government totalling RM168.0 million during the year. As a result, public debt stock as a percentage of total revenue remained elevated at 73.9% in 2010 (2009: 77.9%). Higher borrowings by the state are undertaken for the purpose of funding major economic development projects such as water supplies and low-cost housing. However, the rapid rise in the debt level may yield legitimate concerns on the state's ability to repay its liabilities, particularly when the amount of cash balances available is smaller than the size of public debt. The cash-to-debt ratio has been dwindling to around 2.5% in 2010 from as high as 4.5% in 2006, implying the state's reduced ability to service its debt.

Chart 10: Sabah state public debt (RM million)



Source: National Audit Department

Chart 11: Cash-to-debt vs. debt-to-revenue ratios



Source: MARC Economic Research

Table 2: Sabah state government finances

RM Million	2005	2006	2007	2008	2009	2010
<b>Revenue</b>						
-Tax revenue	623.6	691.4	1,091.1	1,371.0	1,003.9	1,223.4
-Non tax revenue	1,021.4	1,334.5	1,411.8	1,651.5	1,753.1	2,085.8
- Non revenue receipts	133.3	235.0	276.2	318.9	292.9	891.9
<b>Sub-total 1</b>	<b>1,778.2</b>	<b>2,260.9</b>	<b>2,779.1</b>	<b>3,341.3</b>	<b>3,049.9</b>	<b>4,201.1</b>
<b>Expenditure</b>						
-Emolument	na	na	na	556.9	549.4	568.0
-Supplies and services	na	na	na	862.8	792.2	891.4
-Assets	na	na	na	363.3	270.9	401.1
-Grants and fixtures	na	na	na	314.0	395.1	630.0
-Misc.	na	na	na	606.9	855.7	980.3
<b>Sub-total 2</b>	<b>1,637.3</b>	<b>1,922.2</b>	<b>2,193.6</b>	<b>2,703.8</b>	<b>2,863.3</b>	<b>3,470.8</b>
<b>Balance (1- 2)</b>	<b>140.9</b>	<b>338.8</b>	<b>585.5</b>	<b>637.5</b>	<b>186.6</b>	<b>730.3</b>

Source: National Audit Department

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## Risk factors / considerations

- **Commodity prices**

Since the government is heavily dependent on commodities as its main source of revenue, gyrations in international commodity prices will evidently have direct implications on the government's revenue stream. However, demand for commodities such as CPO and crude petroleum will likely remain resilient in the near future due to stronger imports by fast-growing emerging economies like China and India. As such, we do not envisage a significant drop in the state's revenue in the next year.

- **Poverty and income distribution**

High incidence of poverty and rising income disparity are factors which could breed resentment among Sabahans, which, if left unattended, may then result in political instability. Although the likelihood of such an event is rather remote at this juncture, any forces that could trigger political instability can, in the worst-case scenario, affect investor and business confidence, leading to uncertain economic growth.

- **High debt level**

Rapid increases in the state's debt level may compromise the state government's debt-servicing ability, especially when the pace of debt increases has surpassed revenue growth.



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