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State Risk Monitor

SARAWAK

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In a nutshell

- Sarawak's natural resource wealth is a key economic strength. The state ranks only behind Selangor in terms of size of economy, i.e. gross domestic product (GDP), among Malaysia's 13 states. In terms of GDP per capita, only the industrialised states of Penang and Selangor are ranked ahead of it. Notwithstanding the importance of the oil and gas sector, it should be noted that the services and manufacturing sectors are playing increasingly important economic roles. While the oil and gas sector's share of state GDP fell from 25.5% to 21.2% over the 2011-2016 period, the services sector's share rose from 30.1% to 34.4%. This rebalancing is healthy because high GDP growth volatility due to volatile oil and gas prices has negative implications for economic development. As such, the Sarawak Corridor of Renewable Energy (SCORE) initiative, Malaysia's second-largest economic corridor, holds a lot of promise for Sarawak. There are expectations that energy-intensive investments under SCORE, besides reducing Sarawak's vulnerability to downside risks on the external front, could propel the state to high-income status by 2030.

- The state government's commendable fiscal performance means that fiscal risks remain low. Sarawak's fiscal position is sturdy, the result of a string of fiscal surpluses over more than a decade through to 2016. In 2016, state revenue fell by 15.0% to RM5.9 billion from the previous year, its lowest level since 2011, due to low oil prices. There was support, though, from the 7.1% increase in tax revenue on account of a significant rally in palm oil prices. Meanwhile, expenditure restraint led to total expenditure falling by 7.1% in 2016 (2015: +2.4%). Fiscal reserves as of end-2016 were adequate at RM29.4 billion. The reserves, which comprise liquid assets, cover almost 5.3 times of total expenditure or about 12.3 times of public debt. In 2016, public debt shrank by 5.0% (2015: +8.8%) to RM2.4 billion, taking the debt-to-GDP ratio lower to 2.0%. With the government continuing to demonstrate fiscal and debt prudence, the liquid reserve buffers should be ample for Sarawak to tide over any economic or financial shocks over the medium term.

- With natural resource wealth a key economic strength, the state economy is vulnerable to volatile commodity prices, particularly that of oil and gas. This was amply demonstrated in 2016 by the 15.0% fall in state revenue because of significant falls in compensation in lieu of gas rights (-36.3%) and oil rights (-29.5%). While major downturns in oil prices are largely driven by factors that include financial crisis, demand shocks and supply shocks, the oil price collapse starting in mid-2014 appears to be due to a mix of two factors, namely demand and supply shocks. There are, however, indications that the oil market situation is on the mend. Oil prices have surged on, for example, hopes of a rebalancing market. However, the possibility of this happening could be dashed by increasing US shale activity as both oil rig count and output have been steadily rising. This should not come as a surprise because the OPEC (Organization of the Petroleum Exporting Countries) production curbs have incentivised US shale oil producers to step up their oil drilling activities.

Table 1: Selected economic indicators

	2011	2012	2013	2014	2015	2016
GDP per capita (RM)	40632	41493	41766	44611	44089	44333
Real GDP (%)	6.4	1.4	4.3	4.4	3.9	2.3
Unemployment rate (%)	4.1	3.5	3.7	3.1	3.5	3.3
Revenue (% of GDP)	6.5	6.7	6.5	7.5	5.8	4.9
Fiscal balance (% of GDP)	2.5	2.4	1.9	2.6	0.8	0.3
Gross debt (% of GDP)	2.2	2.1	2.1	2.0	2.1	2.0
Net debt (% of GDP)*	-15.8	-17.7	-19.1	-20.8	-22.6	-22.2
Gross debt (% of total revenue)	33.6	31.1	31.7	26.2	36.5	40.8
Net debt (% of total revenue)*	-245.0	-262.4	-294.5	-277.4	-386.9	-456.1

Source: Department of Statistics Malaysia, National Audit Department, MARC Economic Research
*Note: * Net debt is debt left on balance sheet if all debt obligations are paid off with existing cash balances.*

Key Strengths

Abundant natural resources

Rich in natural resources, Sarawak ranks only behind Selangor in terms of size of economy among Malaysia's 13 states. In 2016, the mining and quarrying sector, which includes oil and gas activities, contributed 21.2% towards state gross domestic product (GDP). In terms of GDP per capita, only the industrialised states of Penang and Selangor are ranked ahead of Sarawak.

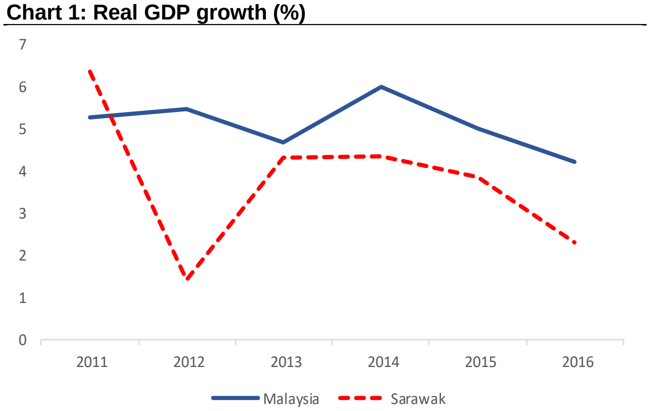
With the oil and gas sector's relatively large GDP contribution, growth volatility is understandably high. Over the 2011-2016 period, for example, Sarawak's GDP growth volatility reached 1.8%, while that for Malaysia stood at 0.6%. Malaysia's lower growth volatility is mostly attributed to the higher contribution of its predominantly domestic-oriented services sector to the national economic output.

It should be noted that both the services and manufacturing sectors play increasingly important economic roles. While the oil and gas sector's share of state GDP fell from 25.5% to 21.2% over the 2011-2016 period, the services sector's share rose from 30.1% to 34.4%. This rebalancing is healthy because high GDP growth volatility has negative implications for economic development. A case in point: over the 2011-2016 period, Sarawak's GDP growth had fluctuated between a high of 6.4% and a low of 1.4%.

Despite Sarawak's high per capita GDP, income disparity is high. While its Gini Coefficient of 0.386 (2016) is the fourth highest among the 13 Malaysian states, there have been improvements. In 2002, for example, its Gini Coefficient of 0.445 was the second highest. The improvement is particularly commendable because the bulk of the state's population resides mostly in underdeveloped rural and remote areas. According to the Population Distribution and Basic Demographic Characteristic Report 2010, Sarawak is the fourth least urbanised state in Malaysia.

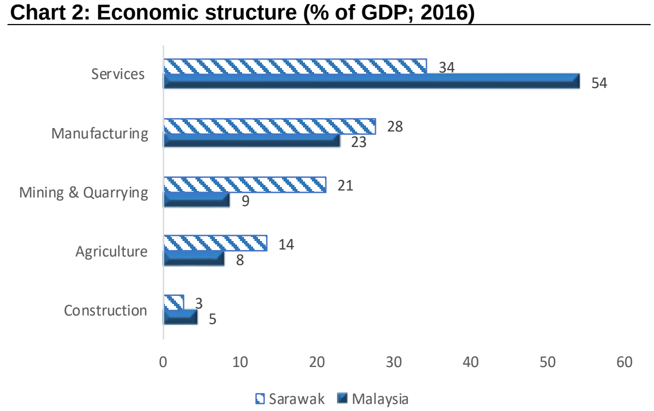
While the Sarawak economy has had a good run in terms of growth, it is strategically important to ensure that there is no lapse in its ongoing economic rebalancing efforts. The Sarawak Corridor of Renewable Energy (SCORE) initiative, Malaysia's second-largest economic corridor, holds a lot of promise for essentially rural Sarawak. There are expectations that energy-intensive investments under SCORE could propel the state to high-income status by 2030. More importantly, Sarawak needs to ensure that there are trickle-down effects from its economic development efforts because such efforts are only meaningful if the socioeconomic well-being of Sarawakians are enhanced.

Chart 1: Real GDP growth (%)



Source: CEIC, MARC Economic Research

Chart 2: Economic structure (% of GDP; 2016)



Source: CEIC, MARC Economic Research

Table 2: Real GDP growth by sector (%)

	2011	2012	2013	2014	2015	2016
GDP	6.4	1.4	4.3	4.4	3.9	2.3
- Agriculture	8.9	3.7	2.3	8.2	2.0	-2.5
- Mining & Quarrying	4.7	-7.2	6.4	1.5	0.3	-2.8
- Manufacturing	6.6	1.3	2.7	4.0	3.6	4.5
- Construction	-1.3	21.3	1.7	-6.0	20.3	-5.2
- Services	7.4	6.2	5.5	6.0	5.8	6.7

Source: CEIC, MARC Economic Research

Sturdy fiscal position

A string of fiscal surpluses over more than a decade through to 2016 has helped build up Sarawak's sturdy fiscal position. In 2016, Sarawak's fiscal surplus came in at RM346.2 million, equivalent to 0.3% of GDP.

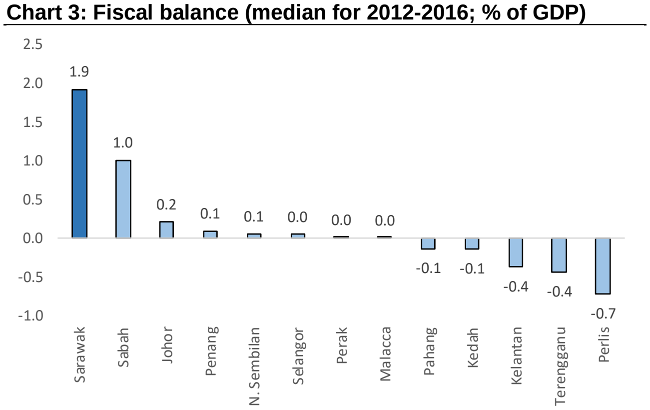
In 2016, state revenue fell by 15.0% to RM5.9 billion from the previous year, its lowest level since 2011. The decline was mainly attributed to a decline in dividend income (-25.6%), compensation in lieu of gas rights (-36.3%) and compensation in lieu of oil rights (-29.5%). There was support, though, from the 7.1% increase in tax revenue, led by a 37.7% jump in sales tax collections on the back of a significant rally in palm oil prices.

Meanwhile, the government's expenditure restraint led to total expenditure falling by 7.1% in 2016, compared to a rise of 2.4% in the previous fiscal year. The first contraction since 2010, it came mainly from a 19.0% cut in the "other expenditure" category, which includes allocations for the Development Fund Account.

The state's fiscal reserves stood at RM29.4 billion as of end-2016. The reserves, which comprise liquid assets such as cash, fixed deposits and equities, cover almost 5.3 times of total expenditure or about 12.3 times of public debt. It is notable that the latter shrank by 5.0% in 2016 (2015: +8.8%) to RM2.4 billion, thus taking Sarawak's debt-to-GDP ratio lower to 2.0%.

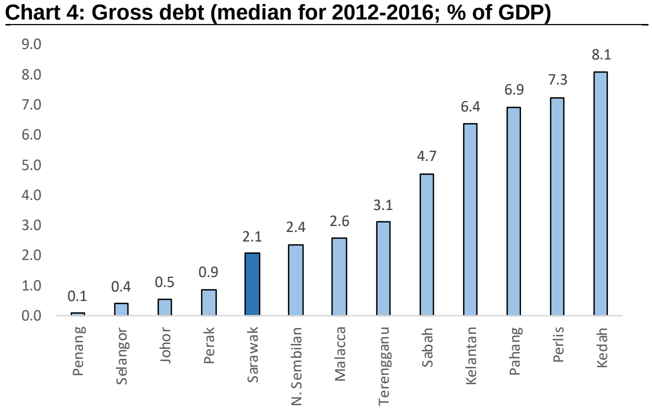
Based on the projection that the global oil market will gradually recover going forward, Sarawak should see a return of growth, albeit at a moderate pace, in oil- and gas-related revenue as well as an improvement in its fiscal balance. In any case, sub-sovereign credit risk remains low as the government continues to demonstrate fiscal and debt prudence. In addition, its debt metrics are favourable and reserve buffers remain adequate to tide over economic shocks in the short to medium term.

Chart 3: Fiscal balance (median for 2012-2016; % of GDP)



Source: National Audit Department, MARC Economic Research

Chart 4: Gross debt (median for 2012-2016; % of GDP)



Source: National Audit Department, MARC Economic Research

Table 3: Fiscal indicators

	2011	2012	2013	2014	2015	2016
Revenue (% of GDP)	6.5	6.7	6.5	7.5	5.8	4.9
Fiscal balance (% of GDP)	2.5	2.4	1.9	2.6	0.8	0.3
Fiscal balance (% of total revenue)	39.3	35.7	29.7	34.3	13.9	5.9
Gross debt (% of GDP)	2.2	2.1	2.1	2.0	2.1	2.0
Net debt (% of GDP)	-15.8	-17.7	-19.1	-20.8	-22.6	-22.2
Gross debt (% of total revenue)	33.6	31.1	31.7	26.2	36.5	40.8
Net debt (% of total revenue)	-245.0	-262.4	-294.5	-277.4	-386.9	-456.1
Gross debt per capita (RM)	889.9	870.6	858.8	876.1	939.1	879.4

Source: National Audit Department, MARC Economic Research

Risk factor

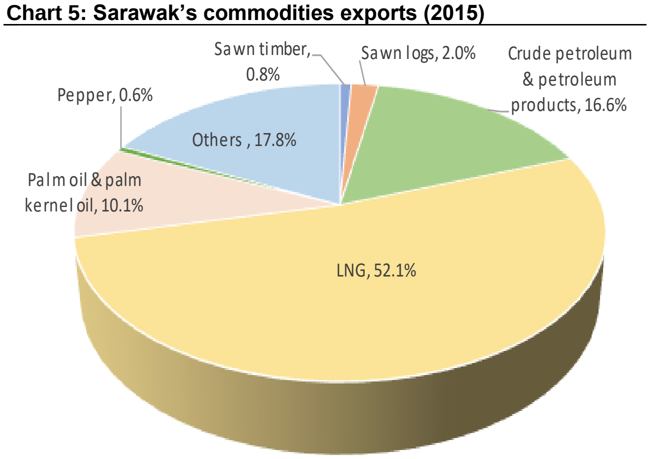
Oil and gas prices

Oil prices have seen large fluctuations over the years, with major downturns largely driven by one or more factors that may include but are not limited to financial crisis, demand shocks and supply shocks. The stunning fall in oil prices from a peak of USD115 per barrel in June 2014, a major global macroeconomic development, appears to be due to two factors, namely demand shocks and supply shocks. There are obviously concerns because persistently weak oil prices will pose a major challenge to Sarawak. In 2016, economic growth had slowed to 2.3%, significantly lower than the previous year's 3.9% and the lowest in the post-Global Financial Crisis (GFC) period. The fall in the GDP growth pace to below 3.0% was somewhat expected considering that oil prices had fallen to its post-GFC low of around the USD30 per barrel in January 2016.

There are indications that the situation in the global oil market is on the mend, with the oil market buoyant since the beginning of 2017. Oil prices have surged particularly since mid-2017 on hopes of a rebalancing market, increasing compliance among OPEC members to agreed-upon production cuts and the strengthening of Saudi Arabian crown prince Mohammad bin Salman's influence, who is agreeable to oil production cuts, after an anti-corruption purge. Going forward, however, there are fears that hopes of a rebalancing market could be dashed by increasing US shale activity. After all, both oil rig count and output in the US have been steadily rising. However, this should not come as a surprise because the OPEC production curbs have become an incentive for a strong drilling response from US shale fields.

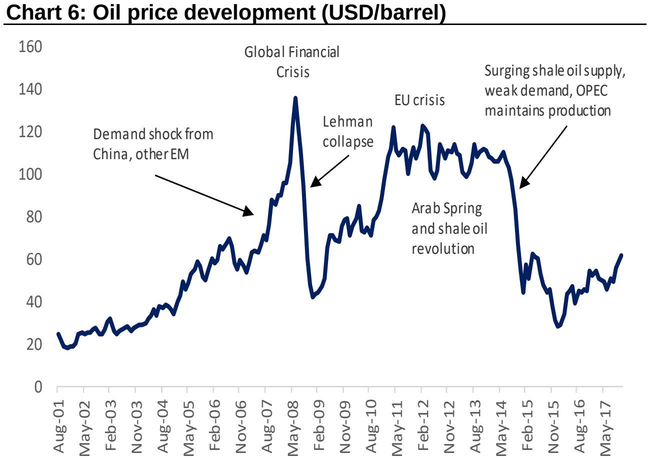
The ongoing developments in Sarawak are expected to diversify the economy further away from an overdependence on commodities, particularly oil and gas. MARC believes that the SCORE initiative will reduce the state's vulnerability to commodity shocks over the medium to long term. Going forward, there should be no let-up in such diversification efforts, even if oil prices recover.

Chart 5: Sarawak's commodities exports (2015)



Source: DOSM, MARC Economic Research

Chart 6: Oil price development (USD/barrel)



Source: Bloomberg, MARC Economic Research

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