Saudi Arabia's 2009 Budget Report

Fiscal Policy Remains Expansionary

24 December 2008

Highlights and NCB Views

On Monday, 22 December 2008, the Council of Ministers endorsed the government's budget for 2009 and announced the final outcome of fiscal operations and macroeconomic performance for 2008. The highlights are:

- The overall fiscal surplus peaked at SAR590 billion in 2008, around 33.7% of GDP. This was largely due to a sharp increase in oil revenues, and a relatively stable growth in actual expenditures. In line with the government's practice, the bulk of the surplus was used to build official reserves and reduce domestic public debt.

- The 2009 budget sees revenues at SAR410 billion and expenditures at SAR475 billion, leading to a deficit of around SAR65 billion. This is the first time the government has budgeted a deficit since 2004. As in previous years, a conservative assumption for average Saudi oil prices of around USD36/bbl has been used in the budget. Our preliminary forecasts suggest that actual revenue will be higher than budgeted, and with a traditional degree of overspending, the government will still be able to register a surplus, though small, at SAR25 billion, or 2.1% of GDP in 2009.

- The escalation of the global economic and financial crisis since mid-Sep has intensified external and domestic headwinds for Saudi Arabia, increasing the downward pressure on growth next year. To overcome these repercussions, the government opted to run a much more expansive fiscal policy than in recent years, with increased spending focused on large physical and social infrastructure. To the extent that a larger part of the input (cement, steel and building materials) is domestically sourced, then by considering the first round impact, the increase in GDP should be higher for capital than current expenditure, which is largely externally sourced. Moreover, it has a far larger long-term multiplier effect than current expenditure, as it enhances productivity.

Macroeconomic Indicators

	2005	2006	2007	2008A	2008F	Latest	Date
Real Sector							
Average Saudi Light Crude, USD/bbl	49.3	60.3	68.5	96.6	100.0	-	-
Average Daily Crude Oil Production, MMBD	9.4	9.2	8.7	9.2	9.3	-	-
GDP at Current Market Prices, SAR bn	1182.5	1335.6	1430.5	1753	1713	-	-
Real GDP Growth Rate	5.6%	3.2%	3.4%	4.2%	4.0%	-	-
CPI Inflation rate	0.7%	2.2%	4.1%	9.2%	10.0%	10.4%	Sep-08
External Sector							
Current Account Balance, SAR bn	337.5	371.0	354.4	564.75	479.6	-	-
Current Account Balance/GDP	28.5%	27.8%	24.8%	32.2%	28.0%	-	-
Net Foreign Assets, SAR bn	589.9	899.8	1171.0	-	-	1689.7	Oct-08
Fiscal Sector							
Revenues, SAR bn	564.3	673.7	621.5	1100.0	955.4	-	-
Expenditures, SAR bn	346.5	393.3	443.0	510.0	506.5	-	-
Fiscal Balance, SAR bn	217.9	280.4	178.5	590.0	448.9	-	-
Fiscal Balance/GDP	18.4%	21.0%	12.5%	33.7%	26.2%	-	-
Monetary Sector							
Growth in Broad Money (M3)	11.6%	19.3%	19.6%	14.1%	-	14.1%	Oct-08
Growth in Private Sector Credit	38.9%	9.8%	20.6%	33.8%	-	33.8%	Oct-08
Average 3M SAR Deposit Rate	3.8%	5.0%	4.8%	-	-	2.8%	10M08

Key: F/ NCB Forecast, A/ MOF Advance estimates

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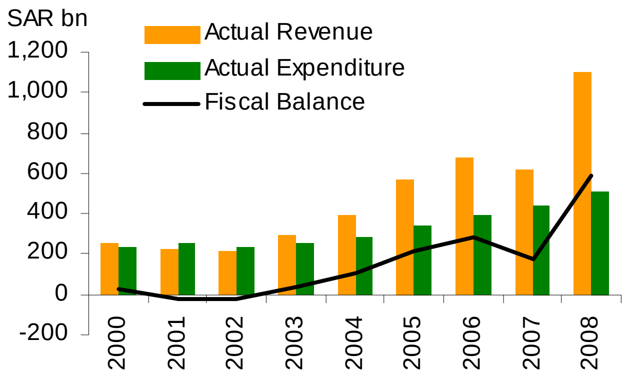
I. Fiscal Performance in 2008

The overall fiscal surplus peaked in 2008. The budget surplus of SAR590 billion was the largest-ever recorded in the Kingdom's history. The fiscal surplus to GDP ratio increased to 33.7% in 2008 from 12.5% in 2007. This was mainly due to the sharp increase in oil revenues, which on average account for 90% of total government revenues. Expenditures hit a record high, but were widely outstripped by revenues. Although the ministry of finance did not specify what areas the budget surplus was allocated to, most probably it was used to build official reserves and retire domestic public debt.

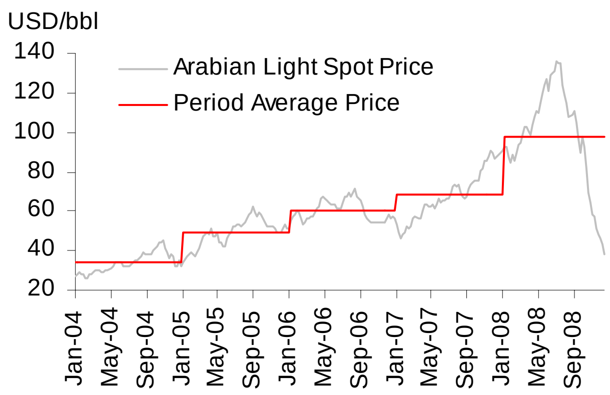
Figure (1): Fiscal Balance



Sources: MOF and SAMA

Fiscal revenues soared to an all-time high, primarily on account of high average crude oil prices in 2008. Despite the plunge in crude oil prices over the past few months, average Saudi Light spot crude oil price in 2008YTD reached USD96.6/bbl, around 39% higher than average 2007 prices. And even though OPEC has cut production by 1.5 MMBD in Nov, it seems likely that Saudi oil output will average 9.2 MMBD in 2008, around 0.5 MMBD higher than 2007. Accordingly, fiscal revenues increased by 77% to a record high of SAR1100 billion, or approximately 63% of estimated nominal GDP.

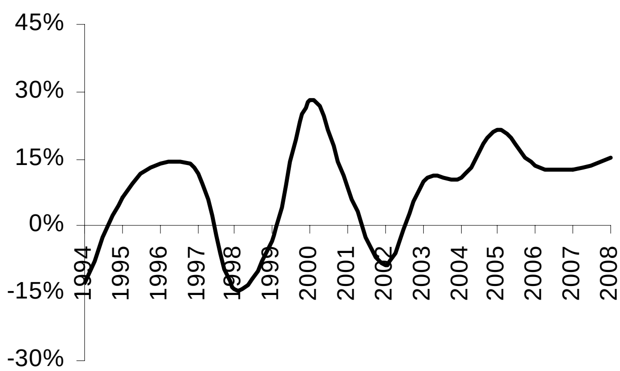
Figure (2): Saudi Light Crude Spot Price



Sources: EIA and NCB

Growth in actual expenditures remained stable. Although actual expenditures are estimated to have come in above budget by around 24%, this was an increase of just 15% from 2007, well below the 77% growth in revenues, and largely in line with the government's expenditure trend in recent years. Despite pressures to improve infrastructure, we believe that fiscal prudence is part of the government's strategy to control inflation and more importantly to crowd in private sector investment. Nevertheless, SAR510 billion is the highest spending level on record. The inflation alleviation package, which includes a public sector wage rise and direct subsidies on goods and raw materials, is one factor for overspending, with higher than planned outlays on infrastructure projects accounting for the rest.

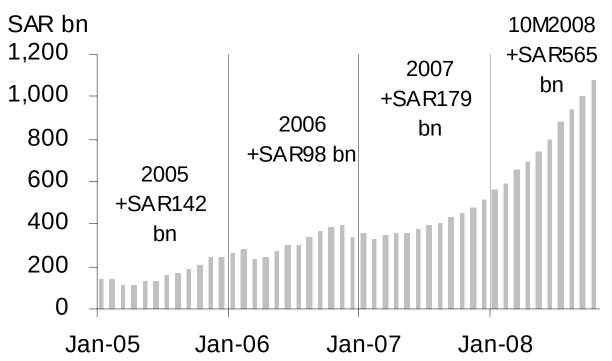
Figure (3): Annual Growth in Actual Expenditures



Sources: MOF and SAMA

Continued large fiscal surpluses helped the government to build up official reserves and pay off outstanding debt instead of expanding expenditure substantially. Fiscal prudence has been partially evident in the sustained increase in the stock of government deposits in SAMA. From Jan 2005 until Oct 2008, these deposits surged from SAR241 billion to SAR1082 billion, as depicted in figure (4) below. Even with the recent sharp drop in oil prices, these reserves, mainly in the form of net foreign assets managed by SAMA, will help sustain public investment expenditure plans over the medium-term.

Figure (4): Government Deposits in SAMA

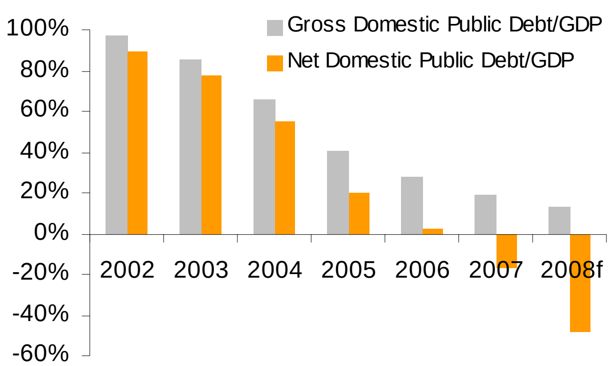


Sources: SAMA and NCB

Over the first ten months of the year, net foreign assets increased by 44.5% to USD451 billion, from USD312 billion in 2007. These assets, which are largely invested in fixed income securities, provide a safety cushion in the event of adverse developments to oil prices. The investment income earned on these reserves is becoming an important source of non-oil revenues. However, given the persistently high level of uncertainty in global financial markets, investment income is expected to fall in 2009 compared to 2008 due to lower interest rates on foreign deposits and securities.

Government domestic debt was reduced further to 13.5% of GDP in 2008, compared to 18.7% in 2007 and a peak of 119% in 1999. Most of the debt is owed to two pension funds (GOSI and the Public Pension Agency), while the remaining is held at commercial banks. It is worth mentioning that the government has more than enough reserves to pay off its entire debt. In fact, net domestic public debt will probably fall to -48% of GDP this year, compared to 89% of GDP back in 2002. However, the current policy of maintaining a certain level of debt is an important monetary policy tool. By issuing debt, the government can absorb liquidity from within the banking sector and therefore reduce the growth in credit and ultimately inflation. Notably, SAMA increased issuance of treasury bills this year to mop up excess liquidity from banks. More recently, however, following tight global credit conditions, the central bank has been indirectly injecting liquidity by lowering the bank reverse requirements from 13% to 7% and cutting the repo and reverse repo rates to 2.5% and 1.5%, respectively.

Figure (5): Domestic Debt in percent of GDP



Sources: MOF, SAMA and NCB

II. Fiscal Budget Outlook in 2009

The fiscal policy stance remains expansionary. Strong fiscal and external positions will allow the Saudi government to maintain an expansionary fiscal policy stance in order to weather any economic downturn ahead. The 2009 budget sees revenues and expenditures at SAR410 billion and SAR475 billion, respectively. This would result in a budgeted deficit of around SAR65 billion, the first since 2004. But since the 2009 budget is likely to be a combination of understated spending and underestimated revenues, we believe that Saudi Arabia will still manage to record a surplus in 2009, even if it will be small compared to previous gains in recent years. With our forecast of USD52/bbl for average Saudi crude oil prices and factoring in a traditional degree of overspending, we project an overall budget surplus of SAR25 billion, or 2.1% of estimated GDP in 2009.

Table (1): Fiscal Revenue and Expenditure

(SAR billion)	2008 Actual	2009 Budget	2009 Forecast
Total Revenue	1100	410	546
Oil	990	383	466
Non-Oil	110	67	80
Total Expenditure	510	475	521
Current	390	250	370
Capital	120	225	151
Deficit / Surplus	**590**	**(65)**	**25**

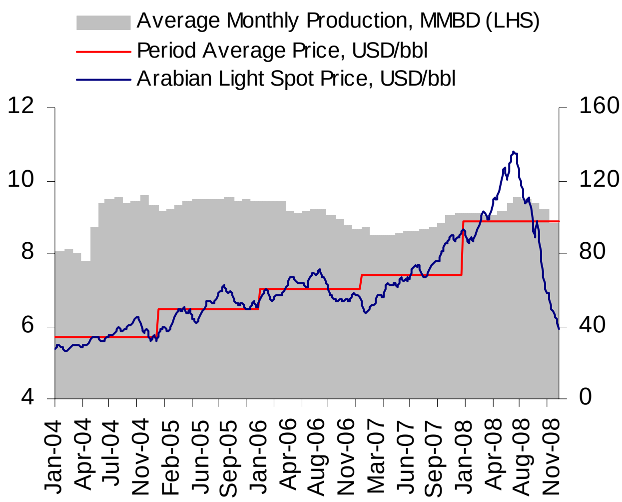
Sources: MOF and NCB

Budgeted revenues are way below the 2008 budget, in line with expectations of lower crude oil prices in 2009. Total revenue for 2009 is budgeted at SAR410 billion, around SAR40 billion, or 9% lower than the 2008 budget. Although an official breakdown is not available, around 85% of this is expected to come from oil. As in previous years, the 2009 budget is based on a conservative oil price assumption. With average oil production likely around 8.5 MMBD, an average price of around USD36/bbl for Saudi oil (equivalent to USD43/bbl for WTI) is probably the implicit price assumed in the government's budget plans. This, however, is USD9/bbl lower than the number that we believe was used for the 2008 budget, which is probably a reflection of the government's concern over the slump in crude oil prices at the time of budget preparation.

We expect lower, but volatile oil prices in 2009. The global oil demand outlook for 2009 has significantly deteriorated due to the deepening financial crisis and global economic recession, most notably in the US and other advanced economies. In its latest monthly report, OPEC has slashed its forecast for global oil demand by 0.36 MMBD to 85.83 MMBD in 2008 and by 1 MMBD to 85.68 MMBD for 2009. On the supply side, OPEC has already cut production by 1.5 MMBD in Nov and 2.5 MMBD to be effective in Jan, in order to stabilize prices. Non-OPEC supply growth is also expected to remain weak in 2009, given the currently tight funding/credit situation. Lower crude oil production, together with modest but ongoing demand growth, especially in emerging economies, will cause oil prices to gradually increase. But just as speculative activity might have added to oil prices in early-2008, it cannot be ruled out that the opposite is now happening, given the decline in future markets activity and rebound in the USD. Accordingly, we expect Saudi crude oil prices to average around USD52/bbl in 2009, down by nearly 47% from average 2008 prices.

This, together with reduced Saudi crude oil production will have an adverse impact on revenues. In line with OPEC production cuts, we expect Saudi oil production to fall by around 0.7 MMBD to average 8.5 MMBD in 2009. With a USD52/bbl forecast for average Saudi crude oil prices, and accounting 85% for oil revenues, we estimate that total revenues will reach SAR546 billion in 2009. Although this is around 50% lower than the actual outturn in 2008, it is still 21% higher than the SAR410 billion estimated in the budget.

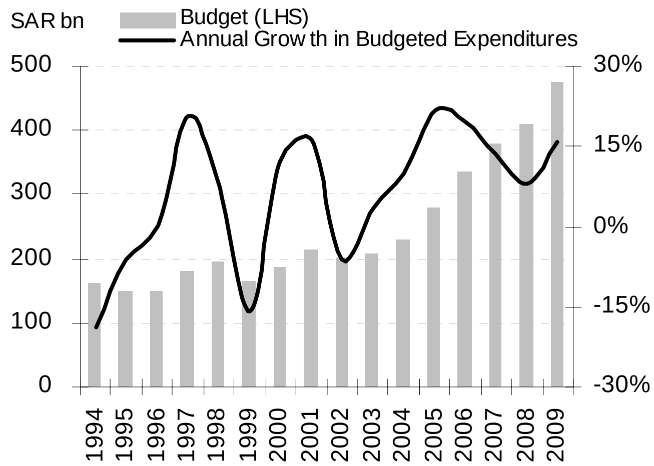
Figure (6): Saudi Crude Oil Prices and Production



Sources: EIA, OPEC and NCB

Nonetheless, the government remains committed to increase expenditure in 2009. In nominal terms, the government budgeted SAR475 billion for 2009 expenditures, out of which SAR225 billion (47%) has been allocated for capital expenditure. This is around 16% higher than the 2008 budget. As depicted in figure (7), growth in nominal budgeted expenditures accelerated in 2009 compared to the pace of growth in 2007 (8%) and 2008 (13%). In anticipation of lower oil revenues, it appears that the 2009 budget profile emphasizes some restraint in current expenditure while continuing to support critical infrastructure projects (see Annex 2). There is a 36% increase in budgeted capital spending, with a focus on improving social infrastructure and projects related to science and technology and e-government. In contrast, current expenditure is projected to increase by only 2%, or SAR5 billion, on the 2008 budget.

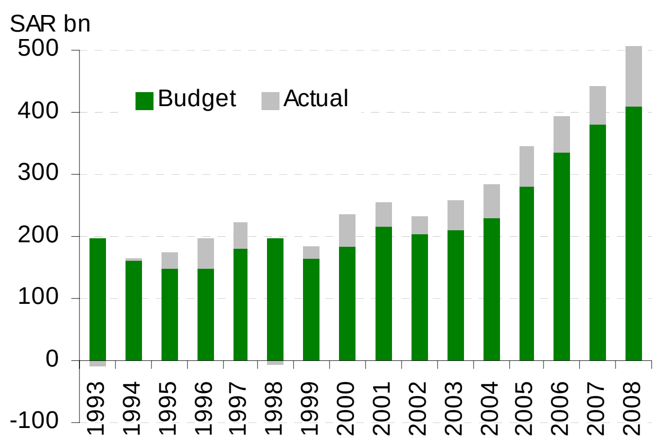
Figure (7): Evolution of Budgeted Expenditures



Sources: MOF, SAMA and NCB

The government will likely exceed budgeted expenditure plans, though cautiously. Actual expenditures will most likely exceed budgeted expenditures by around 10%, which is below the 20% historical average for the last 8 years. Actual expenditures were already 24% higher than budgeted in 2008. Given the currently tight external funding/credit environment, and the government's reiteration of its commitment over physical and social capital expenditure plans, we believe that budgetary overruns are likely to remain a key feature in this cycle to weather any economic slowdown ahead.

Figure (8): Budgetary Overruns



Sources: MOF, SAMA and NCB

Moreover, moderating inflation pressures imply that real growth in the budget is slightly higher than headline figures. Given that approximately 47% of the budget will be allocated to capital expenditures, the recent decline in commodity prices could imply that growth in real budgeted expenditures will be higher than the headline figure of 16%. So far, our estimates suggest that commodity prices will continue to decline in 2009. This, however, may be partly offset by expectations of a weaker USD and hence a nominal effective depreciation of the SAR.

III. Concluding Remarks

Unlike 2008, the year 2009 will prove to be a challenging time for the Kingdom. The broader international economic environment for Saudi Arabia has deteriorated sharply, given the following:

- Lower crude oil prices and reduced production will have an adverse impact on oil revenues.
- Tighter and more costly external borrowing will have a negative impact on private sector investment and confidence levels, as projects may either be put on hold or get delayed.
- Economic growth will slowdown, as contraction in the oil sector is partly offset by growth in non-oil activities.
- Tumbling crude oil prices could reverse the hefty fiscal and current account surpluses of recent years.

However, there are a number of key points in the 2009 budget that lead us to believe that Saudi Arabia will be able to sustain economic growth ahead:

- Strong fiscal and external positions will allow the government to maintain an expansionary fiscal policy stance to whether the economic downturn.
- Increasing capital expenditure could boost non-oil growth in the short-run. It also sends a positive signal to the private sector, which could improve overall confidence levels in the economy.
- Restraining growth in current expenditure could imply higher government savings, and as more resources are injected through specialized credit institutions, this will enhance and support private sector activities.
- Moderating global commodity prices and, to some extent, the recent effective nominal appreciation of the SAR imply that growth in the budget could be slightly larger in real terms.

On a final note, as part of its economic growth and development plans, we believe the government remains committed to structural reforms that promote privatization and foster a business friendly environment to attract investment and enable technology transfer.

Annex 1: Macroeconomic Update

1. Real GDP growth accelerated to 4.2% in 2008 from 3.4% the previous year, on the back of higher crude oil output and investment in productive capacity.

2. Private sector GDP continued to demonstrate strong growth (4.3% in 2008), particularly in transport and communication, manufacturing and construction.

Figure (1):Real GDP Growth, Contribution

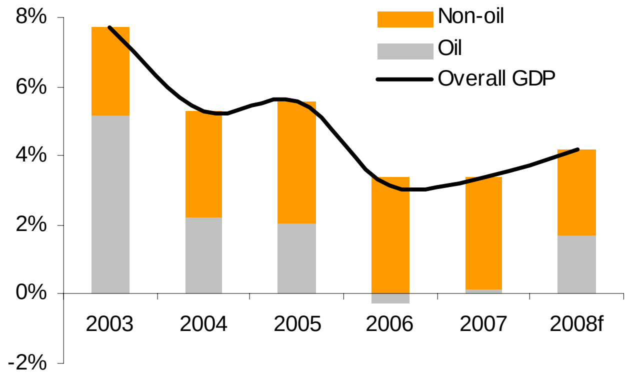
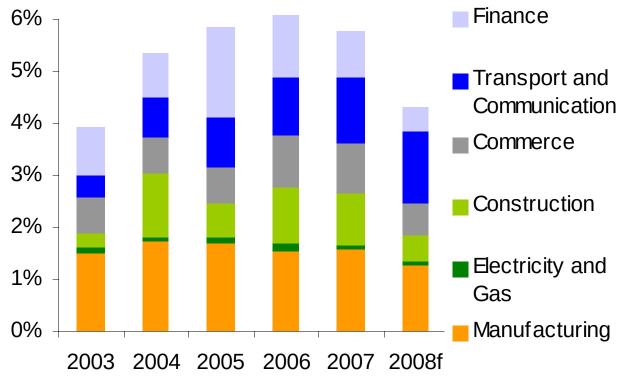


Figure (2): Real Non-oil Private GDP Growth, Contribution



3. This was mainly supported by a pick-up in investment spending.

4. Nominal GDP growth also increased to 23% from 7% in 2007. Again this was the result of higher oil production, but more importantly due to the sharp rise in oil prices in early-2008.

Figure (3): Gross Fixed Capital Formation

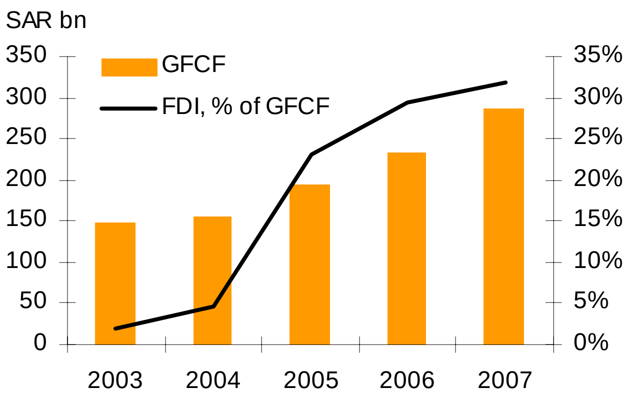
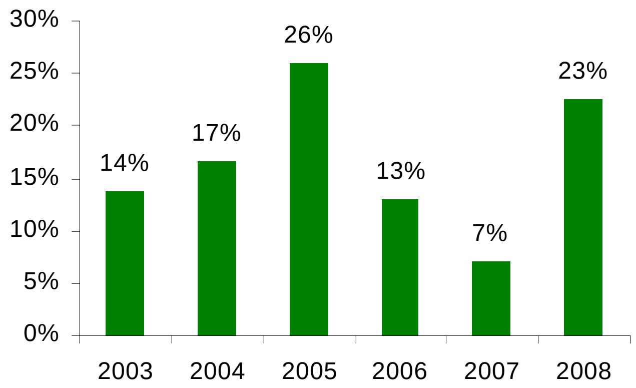


Figure (4): Nominal GDP Growth



5. However, inflation reached unprecedented levels, owing to external factors (mainly food imports) and domestic factors (especially rents).

6. SAMA was forced to follow the US Federal Reserve on interest rate cuts.

Figure (5): Annual Inflation (Cost of Living Index)

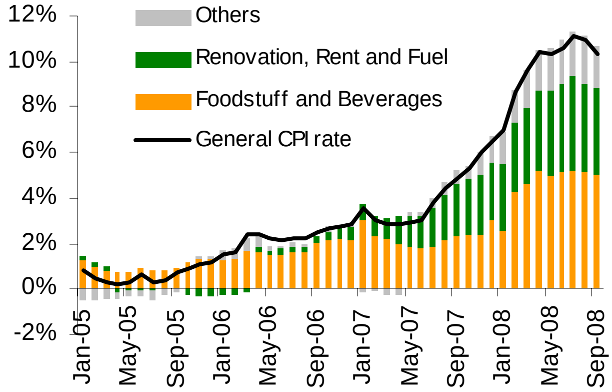
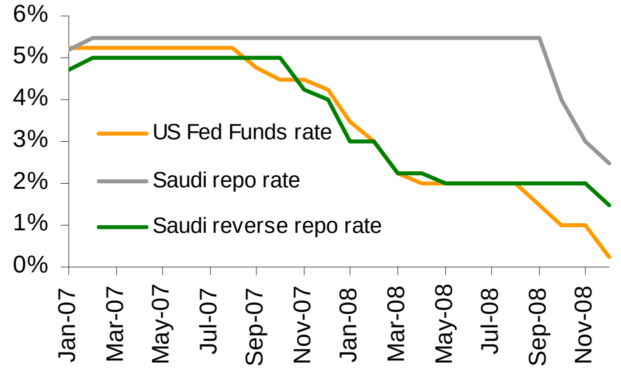


Figure (6):SAMA and US Federal Reserve Policy Rates



Sources: MOF, SAMA, Reuters and NCB

7. As such, monetary aggregates continued to expand with strong credit growth.

8. However, previous hikes on bank reserve requirements put a squeeze on domestic liquidity conditions, with the SAIBOR currently higher than the LIBOR.

Figure (7): Monetary and Credit Aggregates (in percent of broad money stock)

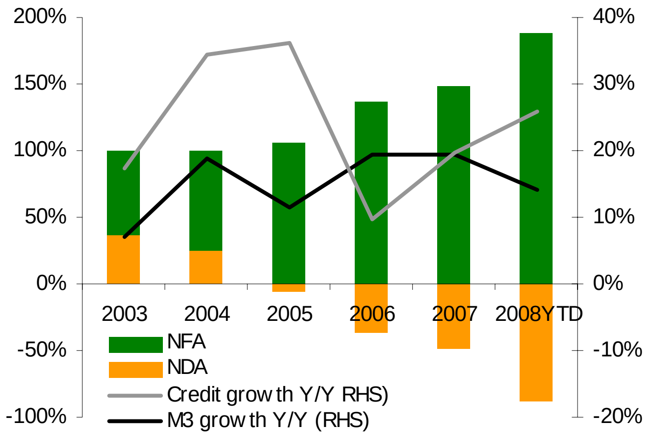
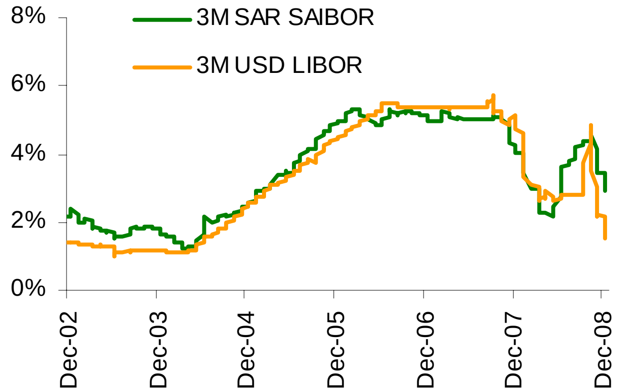


Figure (8): Interbank Market Rates



9. Record crude oil prices fuelled hefty twin balances. The current account and fiscal surplus to GDP ratio increased to 32.2% and 33.7% in 2008, respectively.

10. Accordingly, net foreign assets held by SAMA overshot to USD451 billion by October 2008, providing strong cushion against terms of trade shocks.

Figure (9): Twin Surpluses-to-GDP Ratio

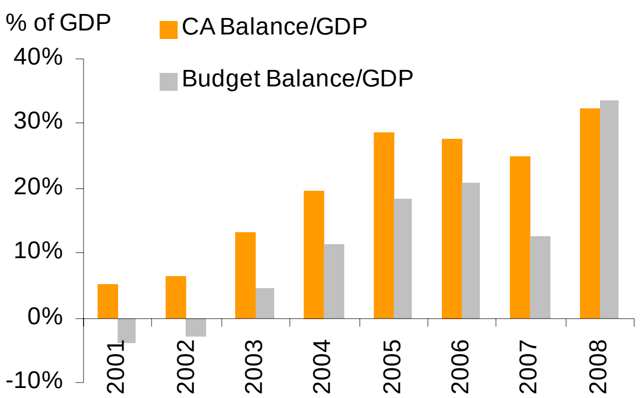
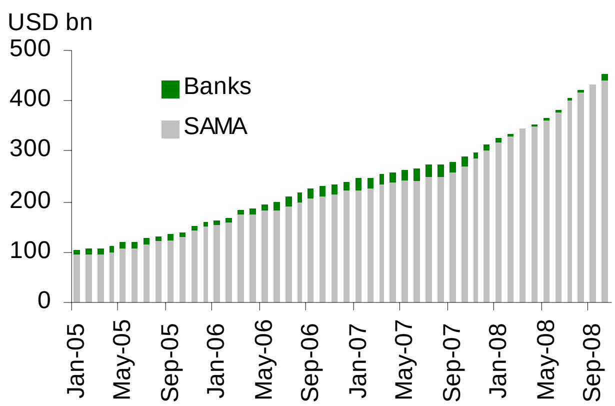


Figure (10): Net Foreign Assets in the Monetary System



Sources: MOF, SAMA, Reuters and NCB

Annex 2: 2009 Budget and Announced Budgetary Allocations by Sector/Institution

The 2009 budget estimates total revenues at SAR410 billion and total expenditures at SAR475 billion, leading to a deficit of SAR65 billion. Out of the SAR475 billion budgeted expenditures, total capital investment represents approximately 47%, inclusive of both green-field projects and capacity expansions. Unlike in previous years, the Ministry of Finance did not provide a breakdown between capital and current expenditure for the designated sectors and/or institutions. Below, we summarize the key budgetary allocations as presented in the official press release.

Sector/Institution	Allocation
Education and Manpower	Expenditures are projected at SAR122.1 billion (26% of total), about SAR17 billion higher over the amount budgeted last year. New projects include 1,500 schools, a new female university (Princess Norah University) and the Medical City at King Saud University. In addition, 2,000 schools will be renovated and work will continue on the 3,240 schools currently under construction. Among other projects, the announcement indicated that at least SAR12 will be spent on the King Khalid University campus project.
Health and Social Affairs	Expenditures are projected at SAR52.3 billion (11% of total), up by SAR8 billion over the amount in the 2008 budget. New projects include primary health care centres, 86 new hospitals, and a number of social centres and welfare offices. The budget also includes appropriations for poverty reduction programs and further development of the Saudi Red Crescent.
Municipality Services	Expenditures are projected at SAR19.8 billion (4.2% of total), an increase of just SAR2.8 billion over the budget in 2008. New projects include inter-city roads, intersection and bridges, road lights, and cleaning related projects.
Transportation and Telecommunications	Expenditures are projected at SAR19.2 billion (4% of total), only SAR2.8 billion higher than the amount budgeted last year. New projects include 5,400 km of roads to be added to 30,000 km of roads currently under construction, ports, airports, railroad developments and new postal services.
Water, Agriculture and Infrastructure	Expenditures are projected at SAR35.4 billion (7.5% of total), up by SAR7billion over the amount in the 2008 budget. New projects include appropriation for the two industrial cities of Jubail and Yanbu.
Specialized Credit Institutions	The government will inject another SAR5 billion in the Real Estate Development Fund, as part of its five-year plan initiated in 2008. In addition, SAR10 billion will be deposited in the Saudi Credit and Saving Bank and an estimated SAR40 billion will be disbursed by other specialized credit institutions.

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