Saudi Arabia's 2013 Budget Report

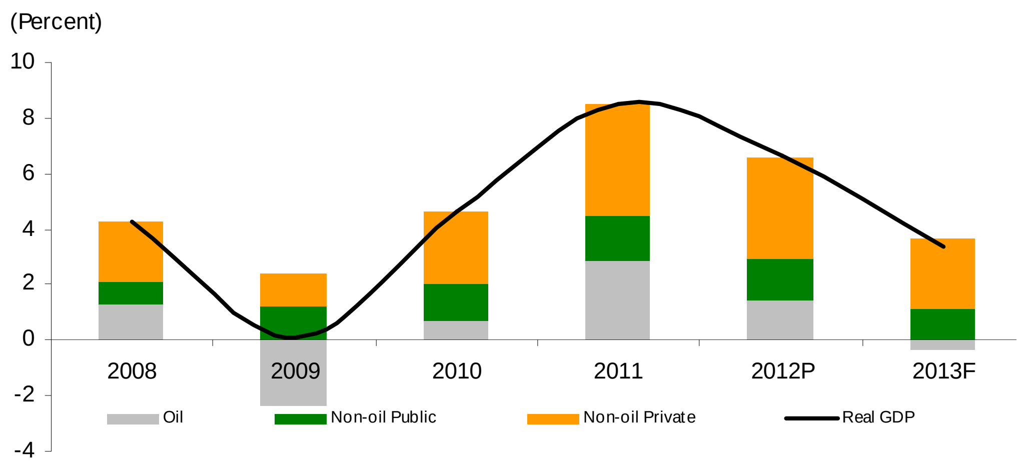
Pursuing Expansionary Fiscal Policy

Contents

Highlights and NCB Views

On Saturday, 29 December 2012, the Council of Ministers endorsed the government's budget for 2013 and announced the final outcome of fiscal operations and macroeconomic performance for 2012. The highlights are:

- The fiscal balance remained in surplus for the third year in a row, edging higher to SAR386.5 billion in 2012, approximately 14.2% of GDP, underpinned by the elevated oil prices and production.
- The Saudi economy continued to grow above the average pre-crisis level in 2012, with real GDP registering 6.8% annual growth, driven by the oil and non-oil sector that grew by 5.5% Y/Y and 7.2% Y/Y, respectively. As we anticipated in our earlier forecasts, growth have eased due mainly to base effects that emanated from the fading out of one-time transfers, estimated at around SAR94 billion, triggered by the royal decrees announced early last year.
- More importantly, the non-oil private sector increased by 7.5% Y/Y, driven by manufacturing and construction that grew by 8.3% and 10.3%, respectively.
- The 2013 budget estimates revenues at SAR829 billion and expenditures at SAR820 billion, projecting a surplus of SAR9 billion. The budget will continue to emphasize both human and physical capital expenditure to support sustainable and balanced growth.
- We project total revenues at SAR1,147 billion and expenditures at SAR870 billion, predicting a surplus of SAR277 billion in 2013. Our forecast is based on an average Arabian light oil price of USD110/bbl for 2013.
- We do believe that the current and future dynamics of global supply and demand points to a tight market balance, as OPEC likely to cut supply next year to counter any escalation in demand downside risks. Hence, Arabian light prices will remain range-bound, protected at a floor of USD80/bbl in 2013, resulting in current account and fiscal surpluses and an increase in net foreign assets.



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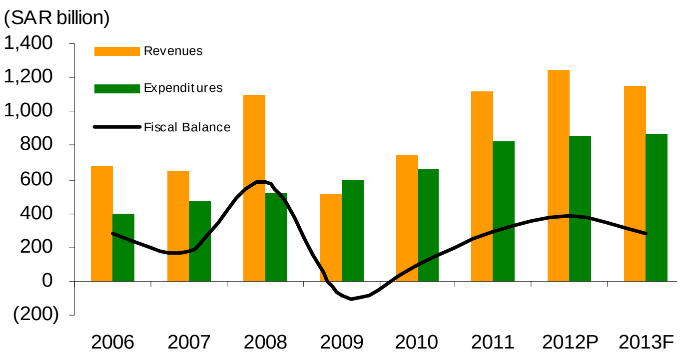
Macroeconomic Indicators	2009	2010	2011	2012P	2013F	Latest	Date
Real Sector							
Average Arab Light Spot (USD/bbl)	59	78	108	105.0	110.0	110.4	11M12
Average Saudi Crude Oil Production (mbd)	8.2	8.2	9.3	9.9	9.7	9.95	11M12
GDP at Current Market Prices (SAR billion)	1413	1690	2511	2727.4	2908.4	-	-
GDP at Current Market Prices (USD billion)	377	451	671	728.3	776.6	-	-
Real GDP Growth Rate, %	0.1%	4.6%	8.5%	6.8%	3.4%	-	-
CPI Inflation (Y/Y % Change)	5.1%	5.3%	5.0%	4.8%	4.5%	3.9%	Nov-12
External Sector							
Trade Balance (USD billion)	105	154	245	268	258	-	-
Current Account Balance (USD billion)	21	67	158	179	144	-	-
Current Account/GDP	6%	15%	24%	24.5%	18.6%	-	-
Net Foreign Assets with SAMA (USD billion)	406	441	536	640	710	628	Oct-12
Fiscal Sector							
Actual Revenues (SAR billion)	510	742	1,118	1240	1147	-	-
Actual Expenditure (SAR billion)	596	654	827	853	870	-	-
Overall Budget Balance (SAR billion)	-87	88	291	387	277	-	-
Budget Balance/GDP	-6%	5%	12%	14.2%	9.5%	-	-
Break-Even Oil Price (USD/bbl)	60.8	64.1	71.1	67.2	70.9	-	-
Financial Sector							
SAR/USD Exchange Rate	3.75	3.75	3.75	3.75	3.75	3.75	Oct-12
Growth in Broad Money (M3)	10.7%	5.0%	13.3%	10.7%	9.1%	13.0%	Oct-12
Growth in Credit to the Private Sector	-0.6%	4.8%	11.0%	17.2%	16.0%	15.2%	10M12
Average 3M SAR Deposit Rate	0.9%	0.7%	0.7%	0.8%	1.0%	0.9%	10M12

Source: Reuters, SAMA and NCB

I. Macroeconomic and Fiscal Performance in 2012

The budget balance remained in surplus supported by robust oil revenues. The increase in oil production coupled with the elevated oil prices resulted in record revenues of SAR1,239.5 billion in 2012, a double-digit growth rate of 10.9% following 50.7% posted in 2011. As such the fiscal balance was pushed higher into a surplus of SAR386.5 billion (or 14.2% of GDP) compared to a surplus of SAR291 billion in 2011. Expenditures hit a new record underpinned by the permanent measures of the royal decrees that were announced in 1Q2011 and a 13th-month pay awarded based on the lunar calendar.

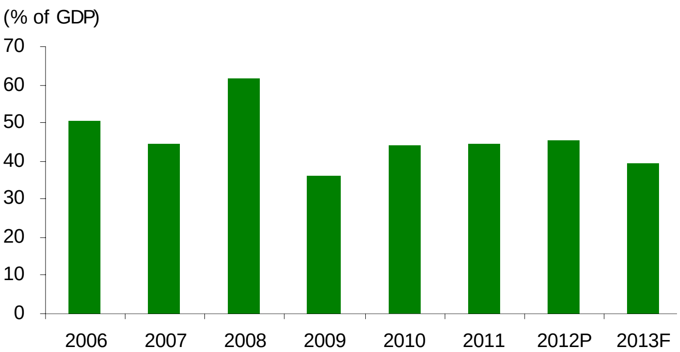
Figure (1): Fiscal Balance



Sources: MOF, SAMA and NCB

Fiscal revenues surged on the back of elevated oil prices and production in 2012. The Arabian light average spot prices has reached USD110.4/bbl in 2012YTD, a 2.1% increase compared to 2011 average prices. In addition, the increase in oil production has supported revenues, with Saudi oil production averaging 9.95 MMBD in 2012YTD, around 0.7MMBD higher than last year's 9.25 MMBD. Consequently, the published pre-closing figures for the current fiscal year ending Dec 2012, showed total revenues of SAR1,239.5 billion, of which SAR1,140 billion represented direct oil revenues, a 76.6% increase over 2012 budgeted revenues.

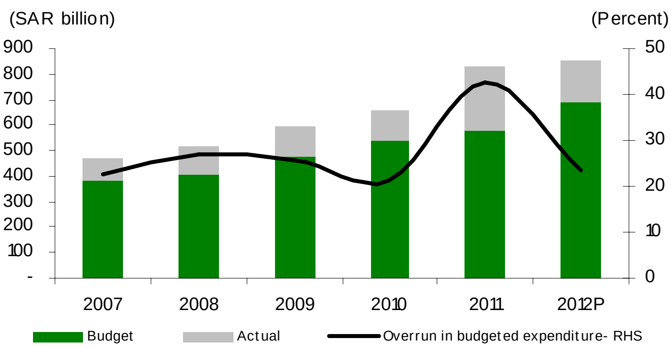
Figure (2): Fiscal Revenues in % of GDP



Sources: MOF, SAMA and NCB

Actual expenditures registered a historical high. 2012's expenditures are estimated to have reached SAR853.0 billion, representing 23.6% increase above budget and about 3.2% higher than actual expenditures in 2011. Capital expenditures remained elevated, posting an estimated SAR264.0 billion. Meanwhile, additional capital expenditure amounting to SAR46.0 billion have been financed from excess surpluses of previous budgets. As expected, the royal decrees issued in 1Q 2011 underpinned the elevated current expenditures during 2012 and will continue to have expenditure repercussions into the medium-term horizon. The permanent measures that included an increase in minimum wage in public sector, the 15% cost of living allowance being fixed in the employees salaries, and an increase in social security contributed to current expenditures that are estimated at SAR589 billion, a record high. Even though the ongoing pace of current expenditures and entitlements raises concerns about fiscal sustainability, it must be noted that the 10-year CAGR for capital expenditure at 24% is substantially higher compared to 11% CAGR for current spending. Thus, the benefits reaped from enhancing the absorptive capacity via vertical and horizontal diversification can mitigate such worries, albeit not offsetting them.

Figure (3): Budgetary Overruns

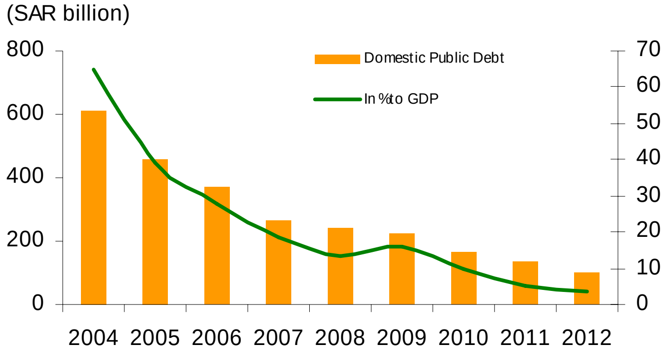


Sources: MOF, SAMA and NCB

Saudi Arabia's external position attained another surplus. The current account increased to reach USD178.7 billion (or 24.5% of GDP), compared to USD158.5 billion last year, registering 12.8% increase due to higher oil export earnings. Imports also increased at a lower pace by 7.7% to reach USD128.2 billion, compared to 23.2%Y/Y last year. Over 10M2012, net foreign assets with SAMA have increased to USD627.7 billion from USD535.9 billion at the end of 2011, leaving official foreign reserves at a very healthy position covering more than 58.8 months of imports, a historical record. SAMA's net foreign assets are expected to grow based on an anticipated higher oil revenues in 2012. As such, they will continue to provide an important buffer to protect the economy from gyrations in oil prices in case of an EU meltdown or a Chinese hard landing scenario.

The Kingdom's domestic debt fell further to SAR98.85 billion, 3.6% relative to GDP. As reiterated in our previous reports, the government has more than enough reserves to pay off the entire debt, yet it opts out from such direction given the low cost of servicing debt. The preference is to finance expenditure plans at home or to diversify investments abroad. In our opinion, a certain level of sovereign debt is necessary as a monetary tool to manage money supply and as a benchmark for pricing corporate bonds and sukuk. Ostensibly, SAMA is in a respite mode given the fact that it was extremely proactive in 2010, issuing Treasury bills worth SAR41.6 billion to mop any excess liquidity that results from maturing Saudi Development Government Bonds (SGDBs), thus, with SGDBs, currently maturing at a mere SAR4.3 billion year to date there is no urgent need to increase the issuance of Treasuries.

Figure (4): Public Domestic Debt in percent of GDP



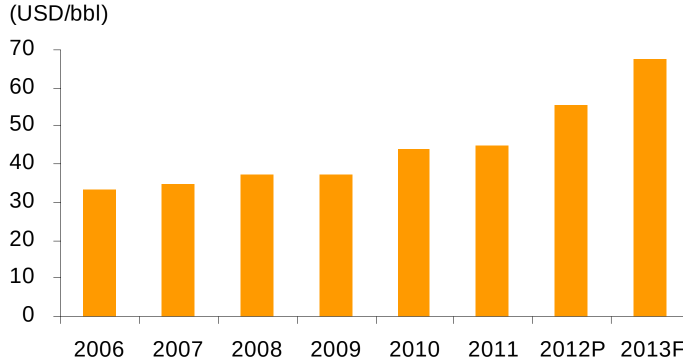
Sources: MOF and SAMA

II. Fiscal Budget Outlook in 2013: Pursuing Expansionary Fiscal Policy

The government is adamant in pursuing expansionary policy to diversify the economy and ensure sustainable growth. The 2013's budget continues to reflect the government's focus on long-term sustainable development that requires investment in infrastructure, education, health care, and social and economic development projects. As expected, education and training continued to be central to the aforementioned strategy, receiving 24.9% of total allocations, with health accounting for 12.2% of the budget. The 2013 budget release estimates revenues and expenditures at SAR829 billion and SAR820 billion, respectively, projecting a budget surplus of SAR9 billion. However, we believe that revenues are underestimated, and the government will still manage to record a substantial surplus in 2013. Meanwhile, strong external positions coupled with huge foreign reserves will underpin capital expenditure. On the execution side, the value of awarded construction contracts through the first three quarters of 2012 retained last year's robust momentum, reaching SAR166 billion compared to the record SAR179 billion awarded during the same time period in 2011.

Oil prices will remain supportive. Although the budget press release does not provide oil price and production level assumptions, we believe that both revenues and expenditures are understated. Based on announced revenues, government assumed next year's oil prices to average $68/bbl. With our forecast of USD110/bbl for the average Arabian light spot prices and an 9.7 MMBD for average oil production in 2013, we project revenues and expenditures at SAR1,147 billion and SAR870 billion, respectively. This would lead to a budget surplus of SAR277 billion, or 9.5% of estimated GDP in 2013.

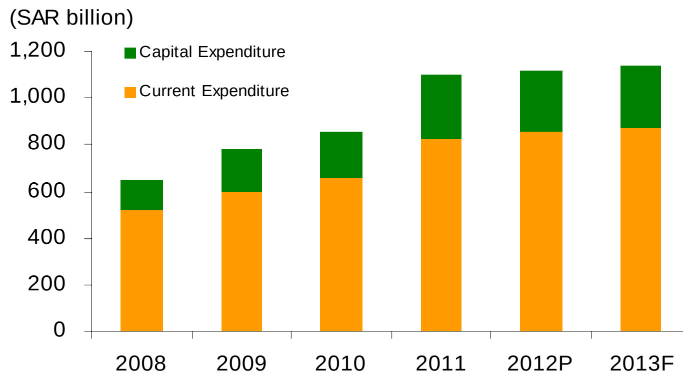
Figure (5): Implicit Budget Oil Price



Sources: NCB

Current expenditures higher than budgeted due to wage bills. The budget still focuses on capital expenditures; however, as reiterated earlier we believe current expenditures will continue its rise due to permanent fiscal measures that were undertaken in 2011. Out of SAR820 billion, around SAR535 billion or 65.2% is allocated to current expenditures, largely to pay for wages and salaries. The remaining SAR285 billion is allocated to capital expenditures, representing around a 7.5% increase compared to 2012. The budget prioritizes spending on physical and social infrastructure development, namely education and health (see Annex 2). However, based on historical evidence actual capital expenditures will end up well below budgeted figures. Therefore, we project capital expenditures at SAR269.7 billion in 2013, while current expenditures at SAR600.3 billion.

Figure (6): Actual Expenditure



Sources: MOF, SAMA and NCB

The government continues to allocate funds to specialized credit institutions to support balanced development. Based on the announcement, around SAR68.2 billion in 2013 will be disbursed by specialized credit institutions to finance industrial projects and to support social development, thus, complementing the surge in private credit growth that recorded 15.2%Y/Y in October 2012, the fastest pace since March 2009. A case in point is the USD20 billion Sadara chemical project, whereby Public Investment Fund (PIF) and Saudi Industrial Development Fund (SIDF) are extending loans worth USD1.8 billion. By the end of October, the PIF had topped Tadawul's major shareholders with SAR290 billion spread across 18 listed companies, reflecting its commitment in providing equity financing as well. In September, the Saudi Credit and Saving Bank have started the process of financing SMEs whose costs will range between SAR0.3-8 million. Alternative measures of finance for SMEs continue to gain ground, with the Loan Guarantee Program "Kafala" facilitating credit worth around SAR1.3 billion by the end of 3Q 2012 to 646 establishments, representing 24.5% of the aggregate beneficiaries since the inception of the program in January 2006.

We forecast oil prices to average USD110/bbl in 2013. After peaking in March, oil prices nose dove as the growth outlook for 2012 became murky given disappointed economic data. Growth dynamics pertaining to Europe and China and OPEC's production have underpinned the downtrend. However, since 3Q 2012 traders have started to balance the possibility of weakening global demand against geopolitical tension in the Middle East, resulting in range-bound prices. Central banks have played a critical role in September, with the ECB and the FED announcing unlimited bond buying programs. Accordingly, on the demand side, the EIA, IEA and OPEC have projected increases in the range of 0.8-1.0 MMBD for global oil demand in 2013. Ostensibly, oil markets seem to be more optimistic about China's economy as confidence indicators recently turned expansionary. On the supply side, OPEC continues to produce above the 30 MMBD quota by around 1.0 MMBD. However, the buildup in inventory and the OECD forward demand cover standing at 59.5 days in October will enhance compliance by OPEC members that reduced production to 30.78 MMBD in November, an 11-month low. Additionally, the Kingdom has recently been unilaterally decreasing its supply, curbing output to a 13-month low of 9.67 MMBD in November. We do believe that OPEC will likely consider supply cuts next year to prevent prices from falling and to ensure market balance .

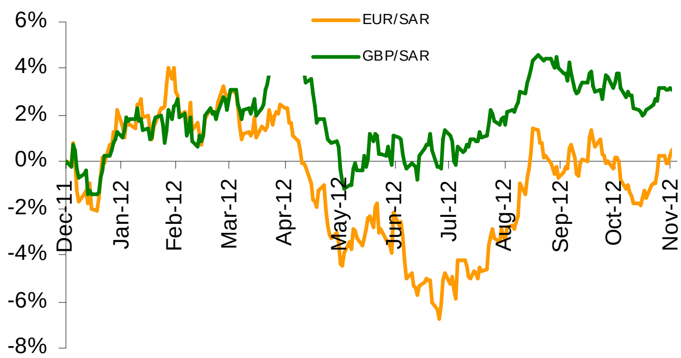
In 2013, historically high oil prices will result in fiscal surplus. Based on our forecast of oil prices at USD110/bbl, we project a fiscal surplus of SAR277 billion or 9.5% of GDP. This will result in oil revenues of SAR1,043.5 billion, representing a decrease of 8.5% compared to actual oil revenues in 2012, which also takes into account a 3.7% decline in export volume. Non-oil revenues are also expected to reach SAR104 billion, 3.9% above actual level in 2012. Actual expenditures will most likely exceed budgeted expenditures by 6.1% to reach SAR870 billion.

(SAR billion)	2012 Actual	2013 Budget	2013 Forecast
Total Revenue	**1,240**	**829**	**1,147**
Oil	1,140	730	1,043
Non-Oil	99	99	104
Total Expenditure	**853**	**820**	**870**
Current	589	535	600
Capital	264	285	270
Deficit/Surplus	**387**	**9**	**277**

Sources: CDSI and NCB

Inflation will likely remain suppressed, registering 4.5% in 2013, largely driven by relatively weaker imported inflation. Cost-push pressures had been subdued during this year since commodities are on course for the second annual drop after 2011, as reflected by the S&P Goldman Sachs Commodity Index and Reuters/Jefferies CRB Index that declined by 1.8% and 3.75% in 2012YTD, respectively. Most Importantly, the intensity of falling global food prices witnessed of late, will keep inflation in check, with the United Nations' Food & Agriculture Organization's index of 55 food items sliding for a second month in November. Against this backdrop, local food prices were pressured downwards, averaging 4.3% YTD, lower than 2011's 5.2% average annual rate. We do believe that the foodstuff category will remain range-bound around 4-5% Y/Y for the remainder of 2012 and early 2013. Meanwhile, the category of rent continued its recent slowdown, reaching 6.7% Y/Y by the end of October, the slowest growth rate since May 2007. Codifying the approved mortgage law is expected to contain rental inflation around 8%, nevertheless, the robust growth in consumer loans will constitute an upside risk to our forecast for headline inflation.

Figure (7): SAR vis-à-vis EUR and GBP



Sources: Reuters and NCB

Ⅲ. Concluding Remarks

The Kingdom will continue its endeavor to diversify the economy and reduce its oil dependence. Evidently, the flurry of project finance sponsored by the government from petrochemicals to power and water projects is indicative of the adamancy to shift to value-added industries. Expanding the absorptive capacity of the Saudi economy to meet the burgeoning demand and employment needs of a youthful population is clearly a strategic orientation that was underscored in this year's budget.

The resilient twin balances and the historically high oil prices will add to government coffers next year, which will sustain capital spending plans even further. Commendably, the government is still aware of the gyrations embedded in oil prices, and as such the Shoura Council, in November, has formally approved a proposal to set up a Sovereign National Fund (NRF) that will be under the supervision of the Supreme Economic Council. The fund will professionally manage and invest the budget surpluses to smooth economic cyclicality. Even though SAMA's prudent strategy of seeking lower risk and higher liquidity at these turbulent times in the credit and money markets have served the country good, an active portfolio management will definitely require an independent body solely responsible for the enormity of handling SAR1.5 trillion in net foreign assets

Going forward, We project real GDP growth of 3.4% for 2013 due mainly to the projected slower growth in oil production, which will decline by nearly 200,00 b/d. However, this contraction in the oil sector will largely be offset by the non-oil sector, which is expected to grow by 7.4%, the second highest on record, driven by the private sector, mainly manufacturing and construction.

Annex I: Macroeconomic Update

1. Crude oil prices inched higher from an average of USD108/ bbl in 2011 to USD110/bbl in 2012YTD and Saudi crude oil production increased by an average of 0.7 million b/d to 9.95 million b/d in 2012YTD.

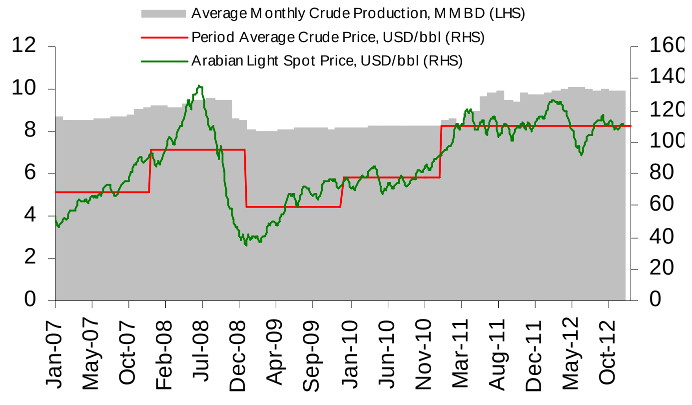


Figure (1): Crude Oil Prices and Production

2. Accordingly, real GDP continued to grow above the 3% average pre-crisis level, registering 6.8% in 2012.

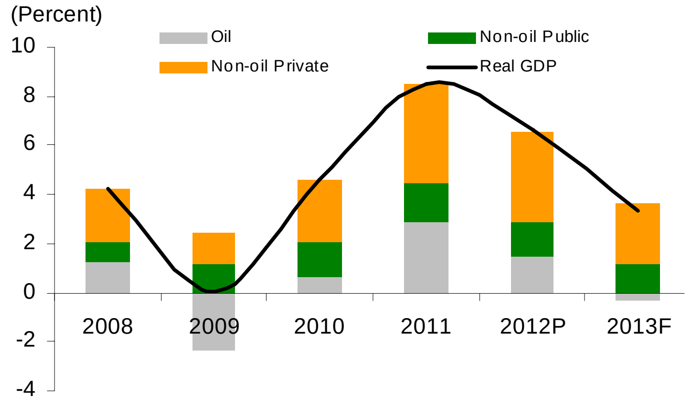


Figure (2): Real GDP Growth, Contribution

3. Non-oil GDP continued to achieve strong growth (7.5% in 2012), particularly in manufacturing and construction.

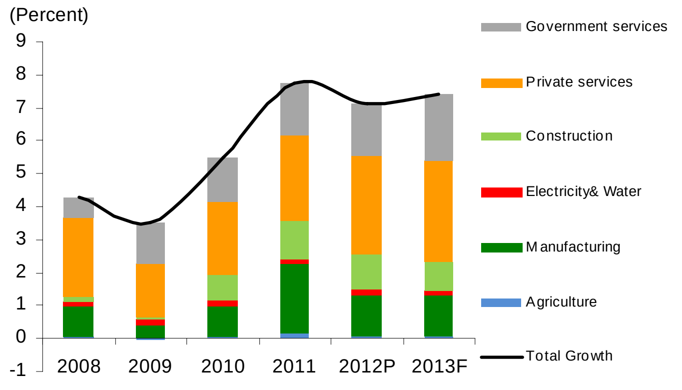


Figure (3): Real Non-oil GDP Growth, Contribution

4. Inflation dropped from 5.0% in 2011 to an average of 4.7% in 2012YTD, on the back of falling global commodity prices that pressured downwards domestic food prices.

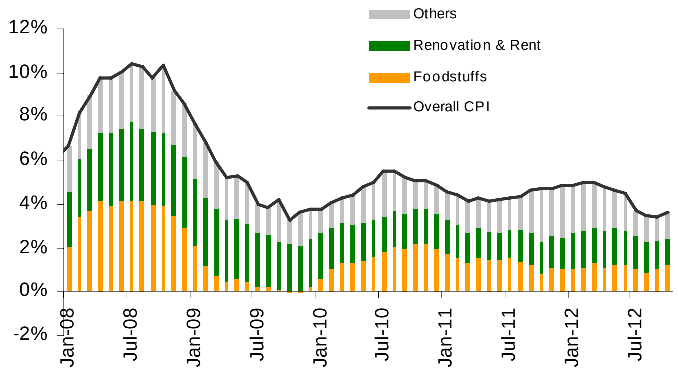


Figure (4): Annual Inflation (Cost of Living Index)

5. The external surplus has increased to 24.5% from 23.6% of GDP in 2011, while fiscal surplus has increased to 14.2% from 11.6% of GDP in 2011, on the back of higher oil revenues.

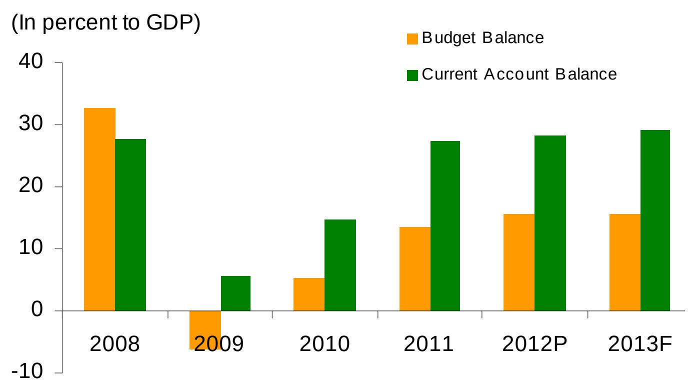


Figure (5): Twin Surpluses

6. As such, net foreign assets have grown to USD627.7 billion in 2012YTD from USD535.9 billion in 2011.

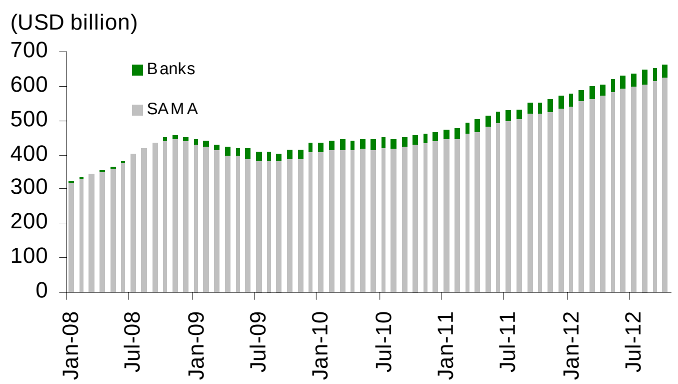


Figure (6): Net Foreign Assets

Sources: MOF, SAMA, Reuters and NCB

Annex 2: 2013 Budget and Announced Budgetary Allocations by Sector/Institution

The 2013 budget estimates total revenues at SAR829 billion and total expenditures at SAR820 billion, leading to a surplus of SAR9 billion. Out of the SAR820 billion budgeted expenditures, total capital expenditures represent approximately 35%, inclusive of both green-field projects and on going projects from previous years. Like 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 SAR204 billion (24.9% of total), about 21% higher than the amount budgeted for last year. New projects include 539 schools, in addition to 2,000 schools that will be renovated and work will continue on the 1,900 schools currently under construction. The announcement renewed its commitment to its overseas scholarship program, with continued focus on building and operating several technical and vocational colleges and institutions.
Health and Social Affairs	Expenditures are projected at SAR100 billion (12.2% of total), about 16% over the amount budgeted in 2012. New projects include primary healthcare centres, 19 new hospitals, and completing the construction work of 102 hospitals and a number of social centres and welfare offices. The budget also includes appropriations for poverty reduction programs.
Municipality Services	Expenditures are projected at SAR36 billion (4.4% of total), an increase of 23% over the budget in 2012. New projects include inter-city roads, intersections and bridges, road lights, as well as sanitary and other environment related projects.
Transportation and Infrastructure	Expenditures are projected at SAR65 billion (7.9% of total), which is 16% higher than the amount budgeted for last year. New projects include 3,700 km of roads, along with feasibility studies and design for 1,523 km of roads. The allocation will also be directed towards new projects and expansions that will disbursed across ports, railways, postal services and the industrial cities of Jubail, Yanbu and Ras Al-Khair worth SAR30 billion.
Water, Agriculture and Manufacturing	Expenditures are projected at SAR57 billion (7% of total), up by 11% over the amount in the 2012 budget. The budget includes appropriations to enhance water resources, as well as to improve water and sewage networks.

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