21 December 2009

Saudi Arabia's 2010 budget

The government's budget for the 2010 fiscal year (31 December 2009 to 30 December 2010) was endorsed by the Council of Ministers on December 21. It was another aggressive budget, with spending maintained at a very high level as the government seeks to ensure that the economic recovery in the Kingdom gains traction. The highlights are:

- A deficit of SR70 billion ($19 billion) is projected, based on expenditure of SR540 billion and revenues of SR470 billion. This is the largest ever deficit the Kingdom has budgeted for in nominal terms and the greatest as a percent of GDP since 2003. Defense, education and healthcare continue to account for the bulk of spending. Another large increase in investment spending is projected.

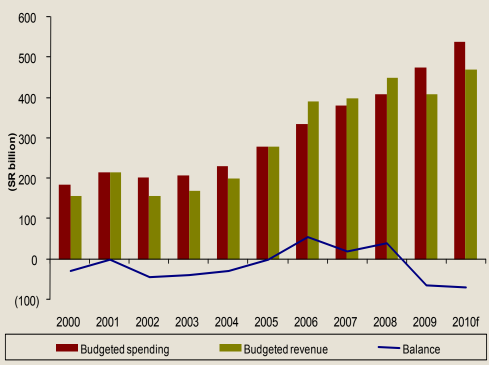
- Government spending played a vital role in supporting the economy during 2009, but weak confidence and tight credit conditions have constrained the private sector response. By maintaining high spending, particularly in the form of investment spending, the government aims to reassure the private sector about its confidence in the economic outlook. The projected deficit is not a problem as it can be comfortably financed through the drawing down of SAMA's net foreign assets, which stood at $389 billion at the end of October.

- A budget deficit of SR45 billion was recorded in 2009, the first since 2002. Revenues were SR505 billion and expenditure was SR550 billion. The deficit was less than the SR65 billion deficit projected in the budget because oil revenues were in excess of the budgeted level. Revenues were less than half of the 2008 level, but 15 percent above their budgeted total. Government spending grew by 6 percent.

- Preliminary economic data for 2009 were stronger than we had anticipated. Real GDP grew by 0.15 percent despite a large contraction in the oil sector. Non-oil private sector growth was 2.5 percent with all sectors of the non-oil economy growing. Lower oil revenues pulled the current account surplus to an eight -year low of $20 billion. Average inflation is estimated at 4.4 percent.

We estimate that oil production of 8.3 million barrels per day at a price for Saudi oil of $50 per barrel ($51 per barrel for WTI) is consistent with the oil revenue projection used in the budget. We believe that this is a conservative assumption and based on our forecast that Saudi oil will average $70 per barrel during 2010 and that government spending will be above the budgeted level, we forecast that the budget will be roughly in balance this year.

Government budget



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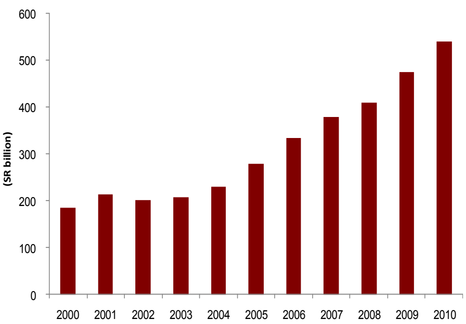
The 2010 budget

For the second year in a row the government has budgeted for a deficit, as spending is kept high in order to stimulate the economy. The SR70 billion deficit is the largest ever in nominal terms, though it is equivalent to only 4.6 percent of GDP. Across the world one of the key economic challenges for 2010 is the withdrawal of government stimulus. This is not a problem for the Kingdom as it is not facing major budgetary constraints (budget deficits are projected to exceed 10 percent of GDP this year in the US and UK) and any deficit can be comfortably financed from SAMA's huge stock of foreign assets.

Expenditure

Total expenditure for 2010 is budgeted at SR540 billion. This is 14 percent above the level budgeted for 2009, but SR10 billion below actual spending this year. Budgeted capital spending has been raised by 16 percent to SR260 billion, this is seven times the amount of 2004 and greater than the total from 1993 to 2004.

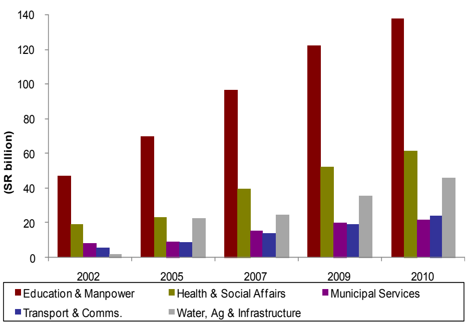
Budgeted expenditure



Based on the data in the budget we estimate that current spending (primarily wages and salaries) is projected to rise by SR30 billion to SR280 billion, though this figure is significantly below recent actual data (current expenditure was SR389 billion in 2008). A 5 percent public sector pay rise will cost around SR4 billion. This is the final part of a three-year deal announced in January 2008 to help alleviate the impact of inflation on public-sector employees. Spending on the government payroll will also be pushed up in 2010 by the payment of a thirteenth month salary. This occurs every three years as a result of the Hijri year being shorter than the Gregorian year.

Spending maintains the focus of recent years and is centered on enhancing physical and social infrastructure. Education is allocated the biggest share of those departments disclosed in the budget. Water, agriculture and (related) infrastructure is awarded the largest increase in spending, up by 30 percent, much of which will go to tackle the inadequacies in water and sewage networks highlighted by the recent flooding in Jeddah. Spending plans for key public sector areas outlined in the budget include:

Spending by sector



Education and training spending is budgeted to rise by 13 percent to SR138 billion. Work will begin on 1,200 new schools and the rehabilitation of 2,000 existing school buildings and will continue on 3,112 schools currently under construction. Campus construction will continue at four newly established universities. The funding of foreign scholarships will focus on technical programs, which should help to fill gaps in the local labor market.

Health and social affairs receives SR61 billion, a 17 percent increase. Ninety-two new hospitals are budgeted for in addition to more social and sport centers and greater funding for poverty reduction programs.

Water, agriculture and (related) infrastructure is allocated SR46 billion, an SR11 billion increase on 2009. Funds are concentrated on building and enhancing desalination plants and improving water and sewage networks, wells and dams.

Transport and telecommunications spending is projected at SR24 billion, up 24 percent on the 2009 level. Work will begin on 6,400 kilometers of roads on top of the 35,000 kilometers currently under construction.

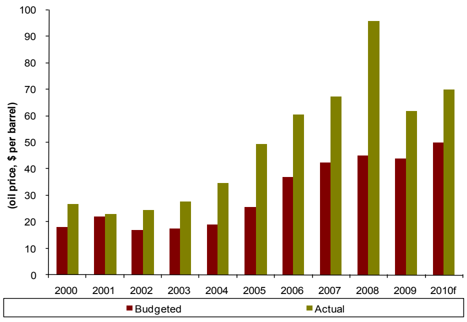
Municipality services receive an increase of SR3 billion, bringing the total to SR22 billion. This is focused on measures to improve road infrastructure within the cities and on sanitary and environment-related projects.

We believe that defense and security is the largest component of government spending, though this data is not reported in the budget. Defense and security accounted for one-third of the 2008 budget and may well have been increased this year and in 2010 owing to tensions around the border with Yemen.

Revenue

Total revenues is budgeted at SR470 billion, up from SR410 billion in 2008. We anticipate that around 85 percent of total revenue will come from oil; an official revenue breakdown was not published. In line with standard practice, the oil price and production numbers on which the oil revenue figure was calculated were not disclosed. We calculate that oil production of 8.3 million barrels per day at a price for Saudi oil of $50 per barrel (equivalent to $51 per barrel for WTI) is consistent with the oil revenue projection in the budget.

Budgeted versus actual oil prices

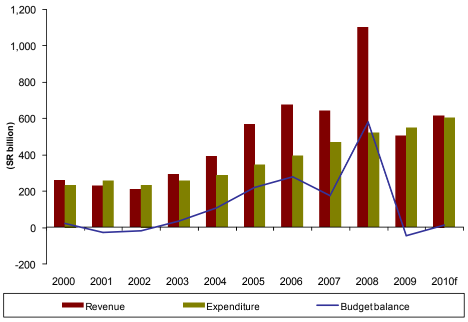


It is usual for the budget to be based on a conservative oil price assumption. Over the last 10 years the actual oil price has averaged over 60 percent higher than the one used for the budget (for 2009, it is likely to be around 40 percent higher). The last year actual oil prices averaged below the budgeted level was 1998. WTI is currently trading at $73 per barrel, 46 percent above the level we estimate is used for the budget. We think that the current price is above that justified by the demand and supply fundamentals owing to the influence of financial investors. The Saudi government has frequently raised its concerns about the impact of financial flows on oil prices and this view reinforces the importance of using a conservative oil price assumption.

Projections for non-oil revenue were not published. The main sources of non-oil revenues are fees and charges for government services and customs tariffs, both of which are likely to grow modestly in line with stronger economic performance. Investment income will benefit from higher (albeit still very low) returns on the foreign government bonds that constitute the bulk of the government's foreign investments. No new policies to raise non-oil revenues were contained in the budget.

Jadwa’s budget forecast

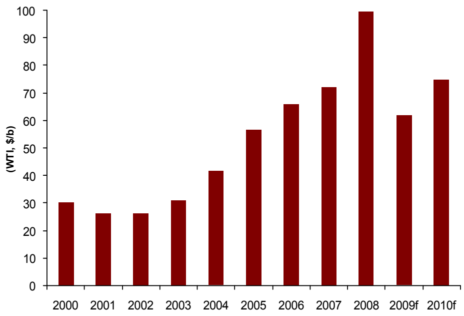
Budget performance and forecast



We forecast a budget surplus of SR13 billion in 2010. This is because we expect the oil price to be higher than that used in the budget and therefore that oil revenues will exceed the budgeted total (see box). We forecast total oil revenues to the budget at SR621 billion and non-oil revenues at SR90 billion.

Spending will be in excess of the budgeted level. Actual spending has averaged 21 percent greater than that budgeted over the last 10 years and even though oil prices were below the budget assumption for part of last year, the budget was still overspent by 16 percent. We project total spending next year at SR616 billion

Average oil price



Jadwa's oil market outlook for 2010

We expect Saudi crude to average $70 per barrel in 2010 (equivalent to $75 per barrel for WTI). Average Saudi oil production is forecast to be 8.3 million barrels per day, up by 2.3 percent from its estimated average for this year.

- Global oil demand is expected to rise during 2010 as the global economic recovery continues. Emerging markets will remain the main source of consumption growth. Leading developed economies still face deep problems and their growth momentum will ease in the second half of the year once the impact of stimulus policies fades, restraining their demand for oil.

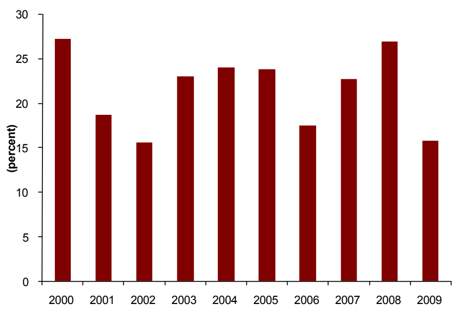
- Non-Opec supply is projected to rise slightly owing to higher output from the former Soviet Union and Latin America.

- Financial flows are likely to have less impact on oil prices in 2010. The need for investors to use oil as a hedge against the dollar should diminish as we expect the dollar to be relatively stable.

The Kingdom is likely to respond to these trends by gradually raising production in the first part of the year in response to higher demand. Other Opec members should do likewise and the Kingdom will probably be more cautious than most in order to hold prices around current levels. Production is likely to be kept unchanged in the second half of the year as the pace of global economic growth slows. Saudi Arabia will be mindful of its role in the G20 and will increase production in the event that prices head towards a level that would threaten the fragile global economic recovery.

Budgetary performance in 2009

Actual spending in excess of budgeted level

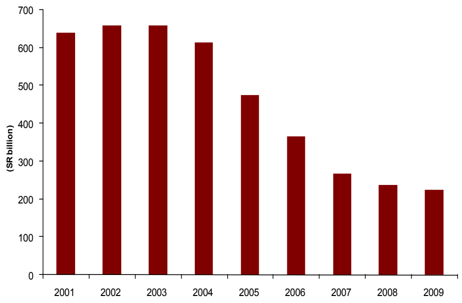


The 2009 budget deficit was the first since 2002. In nominal terms the deficit of SR45 billion was the largest since 1998, though at 3.3 percent of GDP it was surpassed in 2001. Even though the budget was in deficit, the government was able to reduce domestic debt. Expenditure was at an all-time high, but revenues were less than half of their 2008 level.

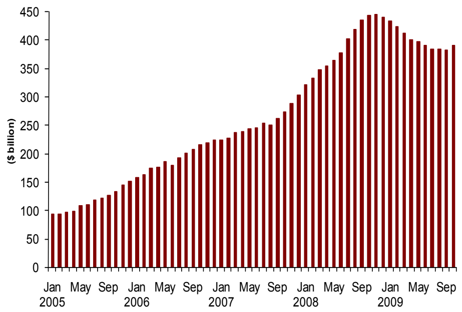
Total expenditure was SR550 billion, 16 percent greater than the budgeted total and 6 percent higher than in 2008. This was the lowest growth in spending since 2002. A breakdown of spending into capital and current expenditure was not disclosed. A public sector pay rise and greater employment in government meant that current spending probably accounted for the bulk of the rise. We think capital spending was up only slightly owing to two offsetting factors. First, many projects have been retendered to lock in lower raw material costs, delaying their start and postponing required government payments. Second, low confidence within the private sector has made tangible signs of progress and contracting opportunities on government projects more important, encouraging government spending.

Revenue totaled SR505 billion, 23 percent above the budgeted level, due to higher than budgeted oil prices. We estimate that the 2009

Government debt



SAMA net foreign assets



budget was based on a price for Saudi oil of $44 per barrel. With just over a week of the year to go, it seems likely that the actual price of Saudi oil will average close to $60 per barrel. With both oil prices and production well down this year, total revenue is more than half the level of 2008 and the lowest since 2004.

We are not greatly concerned that the budget was in deficit even though oil prices averaged around $60 per barrel, as this was the result of the very large level of capital spending. Large outlays on many of the projects currently being undertaken are relatively transitory; for example, it is much less costly to operate a university than to build one. Furthermore, capital spending can be relatively easily scaled back if necessary. We estimate that capital spending accounted for over a quarter of total spending in 2009, compared to an average of 11 percent between 1999 and 2004.

Despite the budget being in deficit, government debt, all of which is domestic, was cut by SR12 billion to SR225 billion (16 percent of GDP) at the end of 2009. We are unclear how this was achieved. Commercial bank holdings of government and quasi-government debt have fallen by SR69 billion over the first 10 months of this year as SAMA retired Treasury bills and bonds in order to free funds that banks could then lend. The remainder of government debt is held by the two government pension funds, GOSI and the Public Pension Agency. We are not aware of the government issuing new debt to the pension funds, but this can be the only explanation for the size of the fall in debt unless bank holdings are excluded from the total.

Why have foreign assets fallen so much?

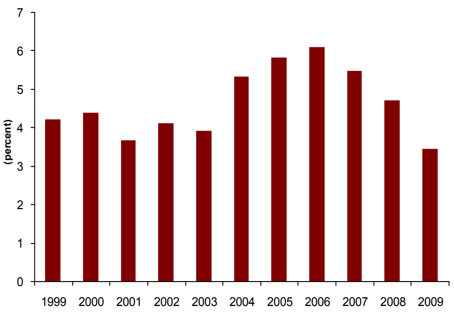
Large budget surpluses over the years between 2003 and 2008 were used to build up foreign assets at SAMA. In contrast, even though the budget deficit was just $12 billion this year, SAMA net foreign assets were down by $49 billion over the first ten months of 2009. The relationship between the budget balance and the change in foreign assets is not tight, but the discrepancy is notable. The bulk of the difference can be accounted for as follows:

- Government deposits in the local banking sector rose by $12 billion.
- The government paid off $18 billion of bills and bonds that were held by commercial banks.
- Funds worth $10.2 billion were transferred to the International Monetary Fund.

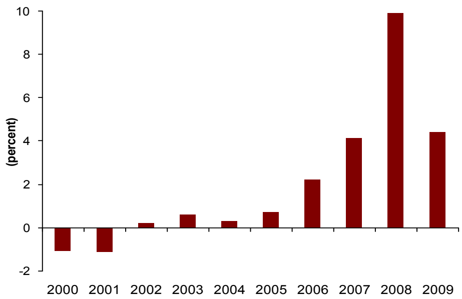
Economic performance in 2009

The budget contained preliminary macroeconomic data for 2009. This showed that while the Saudi economy was affected by the global recession, economic performance was reasonable. Non-oil private sector growth in the Kingdom (which is not distorted by deliberate cuts in oil production) was 3 percent; in contrast the economies of 32 of the 33 economies classified as “advanced” by the IMF are forecast to shrink this year. Much lower oil revenues hit nominal GDP and the current account. The main improvement was the decline in inflation.

Non-oil private sector GDP



Inflation



Real GDP growth was 0.15 percent compared to growth of 4.4 percent last year. This was the lowest growth rate since 2002. The slowdown in growth was due to lower oil production. Oil output was cut to a low of 8 million barrels per day between February and April from a high of 9.7 million barrels per day in July 2008 as demand slumped as the global economy tumbled into recession. Demand has subsequently grown modestly, allowing the Kingdom to increase oil production to the current level of around 8.2 million barrels per day. Nonetheless, we think that average oil production is likely to be significantly lower than it was last year.

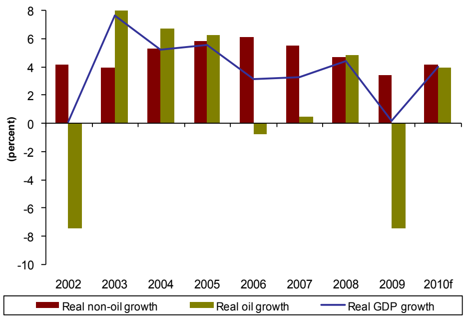
The non-oil private sector grew by 3 percent, the slowest rate since 1998 and down from 4.7 percent last year. The decline is not surprising as 2009 has been a difficult year for the private sector throughout the world as a result of the global recession. Within the Kingdom, these problems were compounded by the very limited availability of bank credit and high-profile troubles at two local companies. Transport and communications was the fastest growing sector, expanding by 6 percent, largely the result of the continued rapid uptake of mobile phone services. The number of mobile phone subscribers in the Kingdom rose by 13 percent over the first nine months of the year. Construction was the next fastest growing sector, at 3.9 percent, reflecting the ongoing government infrastructure investment program.

Nominal GDP plunged by 22 percent, after a gain of 22 percent in 2008. This was caused by much lower oil revenues this year than last. The fall is the largest on record in both nominal and percentage terms. Nominal GDP now stands at SR1.384 trillion ($369 billion), putting the economy just above the size it was in 2006. Even allowing for this large decline, the Saudi economy still accounts for around 45 percent of the total GCC economy.

Inflation fell to an average of 4.4 percent from 9.9 percent last year. Price pressures from all of the external factors behind the surge in inflation over the previous few years have declined. On an annual average basis, food and commodity prices have dropped, bottlenecks have eased and exchange rate movements have been favorable. Rents remain the main source of inflation, though they have also slipped owing to the provision of more government housing and lower building material costs. Official inflation data has only been released for the first ten months of the year, during which the average was 5.3 percent. To get to the official projection, inflation would have to average 0 percent for the final two months of this year. Another measure of inflation, the non-oil GDP deflator, dropped to 2.4 percent from 3.6 percent. The non-oil GDP deflator is the difference between nominal and real GDP and measures the prices of all non-oil goods consumed in the economy.

The current account surplus fell to SR76 billion from a record of SR496 billion in 2008. Although a full breakdown of the current account is not provided, it is clear that the drop was the result of lower oil revenues (oil revenues account for around 80 percent of total current account receipts). Non-oil exports fell by 16 percent (slightly less than implied by the monthly trade data) owing to much lower prices for petrochemicals, plastics and metals (the bulk of the Kingdom’s non-oil exports). Imports also fell, by 21 percent, as a result of lower commodity prices, notably for food and raw materials. It was the first decline in a decade for both non-oil exports and imports.

Real GDP growth



The outlook for 2010

Economic performance is expected to improve in 2010. External and policy conditions have been supportive for some time, with oil prices consistently over $60 per barrel, strong government spending and exceptionally low interest rates, but a lack of consumer and business confidence has held the economy back. With the global economic recovery likely to struggle to retain momentum, we expect the supportive policies to remain in place. Banks have become more comfortable with their exposures and lending to the private sector has started to rise. Further growth in lending should boost business sentiment, lifting share prices, which in turn will bolster consumer confidence. This virtuous circle should result in stronger economic growth in 2010, though ongoing problems accessing credit (particularly from foreign lenders) and weak export markets will constrain the pace of growth. Our other expectations for the Saudi economy in 2010 are:

- Modest growth in oil revenues will result in a low current account surplus and only a small increase in SAMA net foreign assets.

- Inflation is not going to go away. Commodity prices are well above their lows of late last year, the dollar is weaker and there remains a shortage of housing that will continue to push up rents. However, domestic bottlenecks have eased and inflation in the Kingdom's main trading partners will be very low.

- The expected pick-up in economic growth in the Kingdom will generate the need for higher interest rates much sooner than in the US. Given SAMA's limited room for maneuver, this misalignment could result in renewed speculation against the riyal's peg to the dollar. No change to the peg is forecast.

2009 results and 2010 Jadwa forecasts

	2009 Actual	**2010 Jadwa forecast**
Real GDP (% change)	0.15	4.0
Nominal GDP (% change)	-22.0	13.5
Inflation (%)	4.4	4.4
Current account balance (SR billion)	76.7	170.9

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