جدوى للإستثمار
Jadwa Investment

20 December 2010

Saudi Arabia's 2011 budget

The government's budget for the 2011 fiscal year (31 December 2010 to 30 December 2011) was endorsed by the Council of Ministers on December 20. It was stimulatory budget, authorizing huge government investment spending that will provide a major contribution to economic growth. The highlights are:

- A deficit of SR40 billion ($11 billion) is projected, based on revenue of SR540 billion and expenditure of SR580 billion. This is the third year in a row that the Kingdom has budgeted for a deficit. Spending remains focused on defense, education and healthcare. Investment spending is down slightly from the level budgeted for 2010, but at SR256 billion it remains very high.

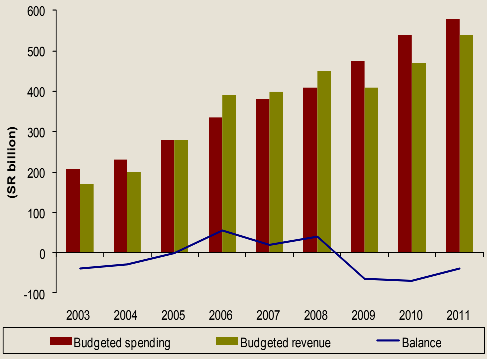
- The budget ensures that government spending will continue to play a highly supportive role in the economy in 2011. With bank lending picking up, consumer and corporate spending rising and the global economy improving, economic conditions are expected to improve in 2011. Although many countries are being forced to cut back spending to containing budget deficits, due to concerns about debt, the Kingdom does not face any problems. Any deficit can be financed comfortably using SAMA's huge stock of net foreign assets, which totaled $429 billion at the end of October and domestic debt was cut to a long-term low of SR167 billion in 2010, equivalent to only 10.2 percent of GDP.

- A budget surplus of SR108.5 billion (6.6 percent of GDP) was recorded in 2010, compared to a budgeted deficit of SR70 billion. Revenues were 56 percent above the budgeted target, at SR735 billion, and well above what we had assumed based on oil prices and production. Spending grew by only 5 percent, the lowest rate since 2002, to SR626.5 billion.

- Preliminary economic data show that the economy bounced back fairly strongly in 2010. Real GDP growth was 3.8 percent, with non-oil private sector growth of 3.7 percent. Utilities, which have benefitted from significant government investment, was the fastest growing sector. Higher oil revenues caused the current account surplus to more than triple to $70 billion. Average inflation is put at 3.7 percent, though this is some way from the average for the first eleven months of the year, of 5.3 percent.

We estimate that oil production of 8.3 million barrels per day at a price for Saudi oil of $56 per barrel ($60 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 $78 per barrel during 2011 and that government spending will be above the budgeted level, we forecast a budget surplus for 2011.

Government budget



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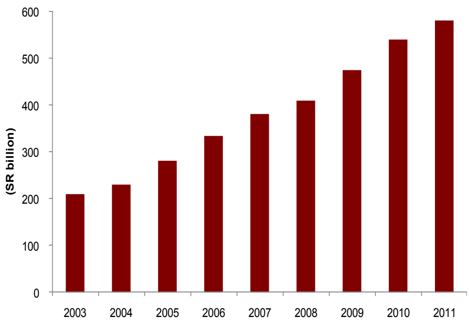
The 2011 budget

Spending is budgeted to hit another all-time high as the government continues to use it to stimulate the economy. Spending has been budgeted to exceed revenues in the last three budgets, though at SR40 billion, the projection for the 2011 budget deficit is the smallest of the three and equivalent to just 2.2 percent of expected GDP. Many countries are being forced to cut back spending to bring budget deficits under control. The Kingdom does not face this constraint, as its planned deficit is much lower than most developed countries, and any deficit that the Kingdom runs will be financed by drawing down foreign assets rather than issuing new debt.

Expenditure

Total expenditure is budgeted at SR580 billion for 2011. This is 7 percent above the amount budgeted for 2010 and is the lowest growth in spending since 2003. In the intervening years budgeted spending rose by an annual average of 15 percent. The budgeted total for 2011 is 7 percent (SR46.5 billion) lower than actual spending in 2010; this is normal as actual spending tends to exceed the budgeted level.

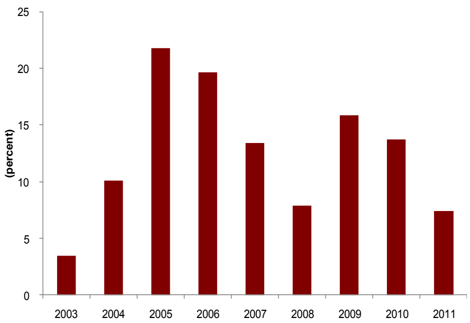
Budgeted expenditure



Budgeted capital spending is down on the 2010 level, at SR256 billion versus SR260 billion in the previous budget. This is the first decline in budgeted investment spending for many years, but it is not a cause for concern. Most investment projects take several years and it is reasonable for the government to sequence its spending in order to avoid stoking inflationary pressures.

It is more important to consider the actual level of investment spending, which at 14.4 percent of expected GDP is still very high. Indeed, budgeted capital spending in 2011 is greater than actual capital spending for the 11 years between 1993 and 2004 and nearly double the 2008 level. It is also important to note that actual capital expenditure tends to be some way below budget. Data for 2009, the latest year for which a breakdown is available, put total investment spending at SR179.8 billion versus a budgeted total of SR225 billion.

Growth in budgeted expenditure



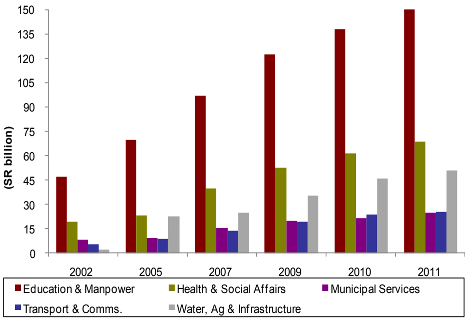
Although a projection was not included in the budget, we estimate that current spending (primarily wages and salaries) is budgeted at SR324 billion, 16 percent above our estimate of the level budgeted for 2010. This probably reflects an increase in the number of employees in the public sector, in addition to the first full year of a pay hike for the military that was introduced towards the end of 2010 and an increase in spending on scholarships for Saudi students abroad. The government had earlier said that it would maintain the 15 percent rise in the pay of public sector employees that was awarded in three annual increments as part of a deal announced in January 2008 to help alleviate the impact of inflation. Actual current spending is likely to be well above the budgeted total (it was SR596 billion in 2009).

Spending maintains the focus of recent years and is in line with the priorities laid out in the 2010-2014 Ninth Development Plan. Education is allocated the biggest share of those departments disclosed in the budget. Spending increases are fairly uniform across the major components outlined in the budget, with municipality services receiving the largest rise, at 13 percent.

Spending plans for key public sector areas outlined in the budget include:

Education and training is allocated SR150 billion, an 8 percent increase. This should fund the completion of the construction of campuses at newly created universities, a continuation of the foreign scholarship program (which cost SR12 billion in 2010) and the construction of 610 new schools. School building provides a good example of how the government's spending program is progressing. The number of new schools budgeted for has fallen each year since 2008, when work was planned to start on 2,074, but the number of schools under construction has risen; currently 3,200 schools are being built. Education and training now accounts for 26 percent of total spending.

Spending by sector



Health and social affairs spending is budgeted to rise by 12 percent to SR68.7 billion. As with schools, the emphasis of the budget is on continuing the work that was started in recent years. Construction of 12 new hospitals is set to commence in 2011, compared to 92 in 2010. The 120 hospitals currently being built are likely to receive a greater proportion of the budgetary allocation.

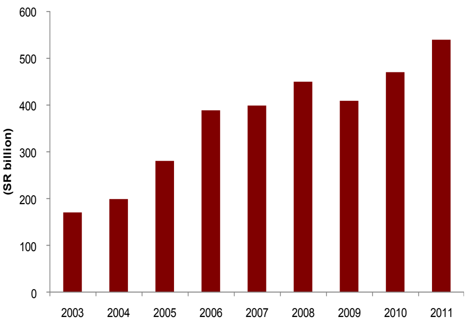
Water, agriculture and (related) infrastructure received SR50.8 billion, a 10 percent increase. New desalination facilities are planned in addition to improved water and sewage networks and dams. Major new projects are intended for the industrial cities of Jubail, Yanbu and Ras Az-Zour at a cost of SR6.35 billion. Budget allocations to this sector have doubled since 2007.

Transport and telecommunications received an increase of 5 percent, lifting the total to SR25.2 billion. Around 6,600 kilometers of new roads are to be added to the 30,200 currently under construction. Funds have also been allocated for the building of four new airports and the redevelopment of Jeddah airport.

Municipality services are awarded SR24.5 billion, a 13 percent rise. This is allocated to various road, bridge and environmental projects, among others. In 2010, municipalities were able to finance spending of SR3.25 billion from their own resources, on top of their budgeted allocation.

Although not disclosed in the budget, we think that defense and security accounted for the largest component of government spending (it was 31 percent of the budgeted total in 2010). Multi-billion dollar defense contracts were signed this year, but with payments to be spread over many years, the impact on spending in 2011 should not be too great. The pay rise for the military will push up defense and security expenditure.

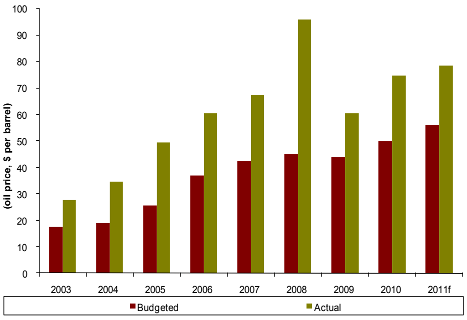
Budgeted revenue



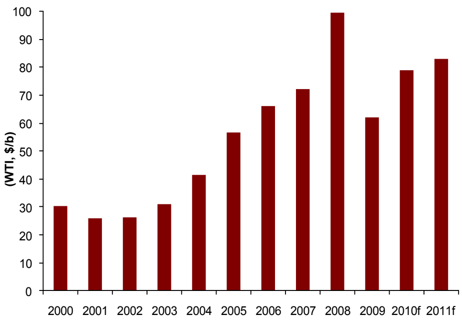
Revenue

Total revenue is budgeted at SR540 billion in 2011. 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 projections used to derive the revenue figure were not disclosed. We calculate that oil production of 8.3 million barrels per day at a price for Saudi oil of $56 per barrel (equivalent to $60 per barrel for WTI) is consistent with the oil revenue projection in the budget.

Budgeted versus actual oil price



Average oil price



It is normal for the budget to be based on a conservative oil price assumption. Over the last decade the actual oil price has averaged over 60 percent higher than the one used for the budget (for 2010, it is likely to be around 55 percent higher). The last year actual oil prices averaged below the budgeted level was 1998. WTI is currently trading at $88 per barrel, 47 percent above the level we estimate is used for the budget.

Projections for non-oil revenue were not published. Fees and charges for government services and customs tariffs are the main sources of non-oil revenues. In both cases these are expected to edge up in line with stronger economic performance. Despite the very high and rising level of government foreign assets, investment income will probably be little changed from the past few years owing to the ongoing low interest rates on US government bonds, which we think constitute the bulk of Saudi government foreign assets. No new policies to raise non-oil revenues were contained in the budget.

Jadwa's budget forecast

We forecast a budget surplus of SR106 billion in 2011. 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 SR674 billion and non-oil revenues at SR90 billion.

Spending will be above the budgeted level. Over the last ten years actual government spending has averaged 21 percent higher than the budgeted amount. The extent of overspending eased in 2010, when it was 16 percent, the lowest level since 1999. Given the more prudent expenditure control together with the low rise in spending budgeted for 2011, we forecast total expenditure of SR658 billion.

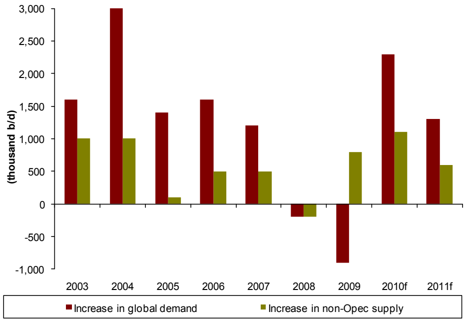
Jadwa's oil market outlook for 2011

Oil prices are expected to be fairly stable during 2011, with WTI forecast to average $83 per barrel (equivalent to $78 per barrel for Saudi export crude). Ongoing demand growth will be offset by a gradual increase in supply from both Opec and non-Opec producers. As a result, we forecast that Saudi oil production will rise by 2 percent to just over 8.3 million barrels per day.

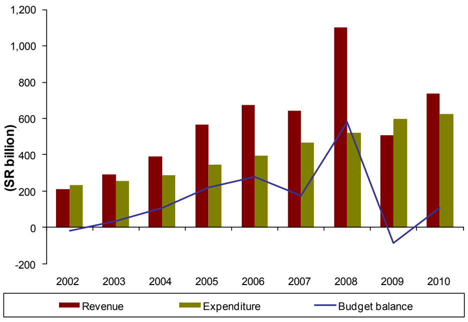
- Oil demand will rise as a result of the growth in the global economy. Demand growth will be fastest among emerging markets, who account for the bulk of new consumption. Demand growth consistently exceeded expectations during 2010, both from emerging markets and OECD countries, and is set to be the second highest in the past 30 years. While this pace will fade, the International Energy Agency (IEA) predicts oil demand growth of 1.3 million barrels per day in 2011, higher than in 2007, when the global economy was booming.

- Producers will respond to the increase in demand by gradually raising supply. Non-Opec production is expected to climb by 0.6 million barrels per day in 2011 according to the IEA, down from 1.1 million barrels per day in 2010. Opec output should creep up. We do not think that a formal increase in production quotas will be considered unless prices exceed $100 per barrel for a

Change in oil demand and non-Opec supply



Budgetary performance



sustained period. With Opec concerned about the global economic outlook, we do not expect compliance with existing quotas to deteriorate rapidly.

- Oil stocks should continue to fall. In 2010 much of the decline was in oil stored offshore and so was not captured in the data on the stocks held by individual countries. With little oil now being stored offshore, the decline should be more visible. Nonetheless, stocks are likely to remain above their five-year average.

Financial flows can play an important role in oil price movements, particularly over the short term. A strong relationship between oil prices and global stock markets, the dollar and other proxies for sentiment about the global economy has emerged in recent years. Movements in investment flows are difficult to predict. Based on our expectations of an improving global economy and a fairly stable dollar we do not think that financial flows will push oil prices too far from the level justified by the fundamentals. Oil has not really been caught up in the surge in commodity prices during 2010, but if other commodity prices plunged there would be a negative impact on oil prices.

Budgetary performance in 2010

The budget returned to surplus in 2010. At SR108.5 billion, the surplus was equivalent to 6.6 percent of GDP. Higher oil revenues, driven by a 28 percent increase in average oil prices, were the reason the budget was able to move into surplus after recording a deficit of 6.1 percent of GDP in 2009. The surplus was much greater than we had anticipated owing to higher than expected oil revenues.

Revenue totaled SR735 billion, 56 percent above the budgeted level and 44 percent greater than in 2009, due to higher than budgeted oil prices. We estimate that the 2010 budget was based on a price for Saudi oil of $50 per barrel. With just over a week of the year left, it seems likely that the actual price of Saudi oil will average close to $74 per barrel. Revenues were some way above what we were forecasting. This is likely to reflect lower spending by state oil company Saudi Aramco. Aramco receives all oil revenues and finances its operations and investment program before passing the remaining oil revenues to the government.

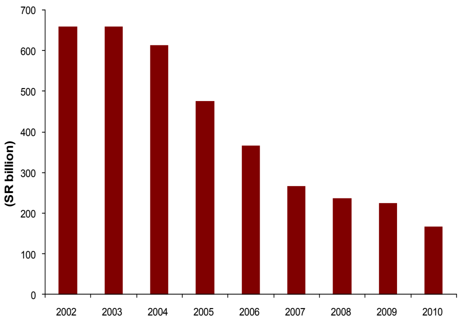
2010 Budget data
(SR billion)

	Budget	Actual	Difference
Revenues	470	735	265
Expenditures	540	626.5	86.5
Balance	-70	108.5	178.5

Expenditure amounted to SR626.5 billion, 16 percent above the budgeted level and 5 percent higher than in 2009. The annual increase was the lowest since 2002 and compares with an average of 14 percent over the intervening period. A breakdown of spending into capital and current expenditure was not published. We think that the rise was the result of higher current spending. A thirteenth month salary was awarded (although this occurs every three years as a result of the Hijri year being shorter than the Gregorian year it appears not to be contained in the budget), pay for military and university lecturers was lifted during the year and the number of government employees probably went up.

Investment spending is likely to have fallen. This is not a concern, as investment expenditure was ramped up in the first half of 2009 as the global economy fell into recession and oil prices slumped to below $35 per barrel. Work was started on projects that could be quickly implemented in order to support the economy. With economic conditions better in 2010, there was less need for such a rapid stimulus.

Government debt



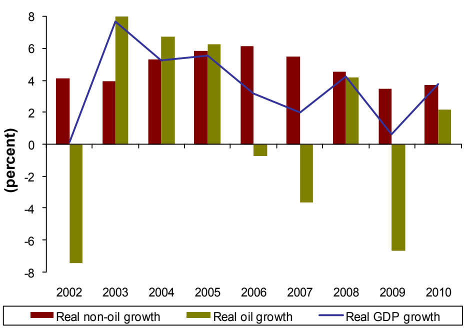
Government debt was cut by SR58 billion to SR167 billion. This was the largest reduction since 2007 and lowers the total to 10.2 percent of GDP, compared with a high of 119 percent of GDP in 1999. Commercial bank holdings of government and quasi-government debt securities have risen by SR13 billion over the first 10 months of this year, owing to a SR21.4 billion increase in Treasury bills. Bank holdings of longer-term government bonds are down by SR12.5 billion. The remainder of government debt is held by the two government pension funds, GOSI and the Public Pension Agency. In previous years government debt held by these institutions was exchanged for assets managed by other government agencies. We think similar swaps enabled the reduction in overall debt in 2010.

It is important to note that the initial estimates of budgetary performance contained in the budget statement tend to be revised. Generally, both the revenue and expenditure figures are increased, though the latter is usually by a larger amount. Over the past five years total spending has been revised up by an average of 3.6 percent from the preliminary estimate contained in the budget and revenue by an average of 1.5 percent. For 2009, the spending total announced at the time of the 2010 budget was subsequently revised up by 8.4 percent (SR46 billion). However, even if spending in 2010 was revised up by this proportion, the budget would still be in surplus.

Economic performance in 2010

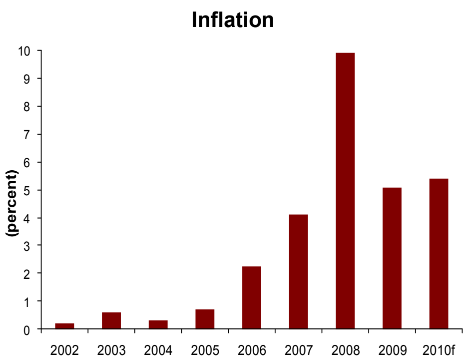
The budget contained preliminary macroeconomic data for 2010. This showed that economic performance improved. Economic growth rose to 3.8 percent, in part due to higher oil production. Non-oil private sector growth was little changed on 2009, despite the improved local and global environment, at 3.7 percent. For every sector apart from government services, growth was below the level targeted in the 2010-2014 Ninth Development Plan. Higher oil revenues caused the economy to resume growth in nominal terms and lifted the current account surplus.

Real GDP growth



Real GDP growth rose to 3.8 percent from 0.6 percent in 2009. Stronger economic growth was due primarily to higher oil production. The Kingdom has been able to increase oil production throughout 2010 as global demand has picked up in line with the improvement in the global economy. The oil sector grew by 2.1 percent, above the growth in oil production, due to the project work taking place in the sector. Reduced oil output was the key factor explaining the weak economic performance in 2009. Government services made a robust contribution to economic growth, rising by 5.9 percent, the second fastest rate since the early 1980s.

The **non-oil private sector** grew by 3.7 percent in 2010, up from growth of 3.5 percent in 2009. High government spending, greater availability of bank credit, a general improvement in consumer and



corporate confidence and partial recovery in the global economy all contributed to the upturn. Nonetheless, given this improved environment, the gain was disappointing. Electricity, gas and water was the fastest growing sector, up by 6 percent due to high government investment to meet rapidly growing domestic demand. For the first time since 2003 transport and telecoms was not the highest growth sector, largely because the level of mobile phone penetration is close to saturation, though growth was still healthy, at 5.6 percent. Manufacturing was the next quickest growing sector, at 5 percent, due to new petrochemical facilities opening and higher international demand. Finance was the weakest sector, expanding by just 1.4 percent.

Nominal GDP expanded by 16 percent in 2010 after shrinking by 21.1 percent the previous year. The rise was because oil revenues were much higher than they were in 2009, with both prices and production up. At SR1,630 billion, the economy is still 8.5 percent smaller than it was in 2008.

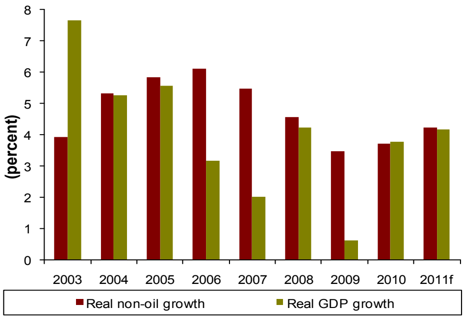
Inflation was put at an average of 3.7 percent, compared to 5.1 percent in 2009. It is unclear how this figure was calculated, given that inflation has averaged 5.3 percent over the first eleven months of 2010. Jumps in the international prices of many commodities was the leading cause of higher inflation in 2010, with food price inflation particularly sharp, rising from 1 percent year-on-year in December 2009 to 8.5 percent year-on-year in November 2010. Rents remain the main source of inflation, though they have stabilized at around 9 percent in year-on-year terms over the past six months. Other sources of domestic inflationary pressures have been fairly subdued. Another measure of inflation, the non-oil GDP deflator, fell to 1.5 percent from 2.4 percent in 2009. 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** rebounded to SR260.9 billion from an eight-year low of SR85 billion in 2009. Although a detailed breakdown of the current account is not published, it is clear that the rise was due to higher oil revenues (oil revenues account for around 80 percent of total current account receipts). We estimate that higher oil prices lifted oil revenues by 25 percent to SR762 billion. Stronger prices also helped non-oil exports, primarily petrochemicals and plastics, to hit a new all-time of SR124 billion, a 14 percent rise. In contrast, imports were up by only 0.7 percent to SR326 billion. Imports of machines and equipment are well down so far this year, as many projects have moved from the procurement to the implementation stage. Data on the other components of the current account was not published.

The economic outlook for 2011

The Saudi economy is expected to strengthen in 2011. Economic growth will rise, financial conditions will get better, inflation will be contained and the budget will remain in surplus. Government spending will continue to be the main driver of growth, with the contribution from the private sector expanding as the availability of bank credit improves and business and consumer confidence revives. Oil prices should rise owing to robust demand from emerging markets, though the economies of major developed countries will remain subdued.

Real GDP growth



We forecast that economic growth in Saudi Arabia will rise to 4.2 percent in 2011. Growth in both the oil and non-oil sectors will pick up. Oil production is forecast to respond to rising demand. High government spending will remain the main driver of the non-oil economy, supported by greater bank lending. The fastest growing sectors of the economy, utilities and construction, rely heavily on government spending.

Inflation will stay at elevated levels in 2011, averaging 5.3 percent. Rents will remain the leading source of inflation; other inflationary pressures will be external, mainly in the form of commodity prices. Domestically-driven inflationary pressures should still be muted, though there is a risk of a gradual increase in inflation expectations. Although inflation will be well above the historical norm, we expect interest rates to remain very low and do not anticipate the adoption of new policy measures to tackle rising prices. We do not foresee any changes to the riyal's peg to the dollar.

While the economic picture will improve, performance will still be very heavily dependent on the government. Tough credit conditions and a weak global economy will keep growth of the non-oil private sector below that of the boom years around the middle of the last decade and activity will be dominated by government contractors.

2010 results and 2011 Jadwa forecasts

	2010 Actual	2011 Jadwa Forecast
Real GDP (% change)	3.8	4.2
Nominal GDP (% change)	16.0	8.5
Inflation (%)	3.7	5.3
Current account balance (SR billion)	260.9	233.5