جدوى للإستثمار
Jadwa Investment

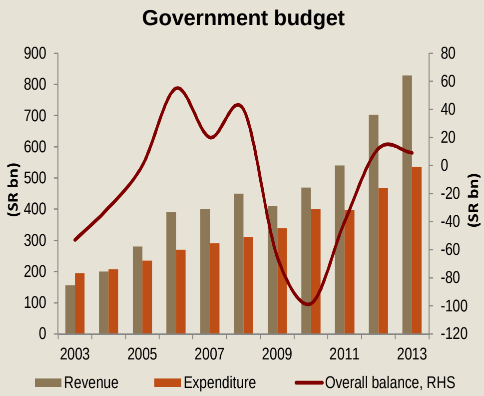
29 December 2012

Saudi Arabia's 2013 budget

The government's budget for the 2013 fiscal year (31 December 2012 to 30 December 2013) was endorsed by the Council of Ministers on December 29. It was another expansionary budget with a record spending which will play a vital role in supporting the economy. The highlights are:

- A surplus of SR9 billion ($2.4 billion) was projected, based on revenues of SR829 billion and expenditure of SR820 billion. This is the second consecutive year since 2008 that the Kingdom has budgeted for a surplus. Education and healthcare remain the focus of government spending, accounting for 37 percent of total spending.
- The budget highlights again the government's intention to continue to stimulate the economy. Budgeted investment spending, raised by 28 percent to an all-time high of SR285 billion, will support healthy economic growth and provide encouragement and opportunities for the private sector at a time of global and regional uncertainty. While revenue projection is less conservative than in previous years, but in the event of a shortfall in revenues, any deficit can be financed comfortably by drawing from SAMA's huge stock of foreign assets, which stood at $635 billion at the end of November.
- A budget surplus of SR386 billion was recorded in 2012 (Jadwa: SR341 billion), compared to a budgeted surplus of SR12 billion. The surplus was the second largest on record, after 2008 of SR580.9 billion. Total revenues were a record high of SR1.24 trillion (Jadwa: SR1.19 trillion) and total spending was also at an all-time high, of SR853 billion (Jadwa: SR847 billion). Spending grew at 3.2 percent year-on-year, a moderate rate compared to the previous two years. This was expected as it came in addition to a massive 26.4 percent expenditures growth last year which was mostly allocated to current spending.
- Preliminary economic data show that 2012 was a healthy year for the economy with real GDP growth of 6.8 percent. Non-oil private growth maintained a strong growth of 7.5 percent year-on -year, with construction and transport and communications sectors expanding at double-digit rates. The budget announcement also showed another revision to the 2011real GDP growth from 7 percent to 8.5 percent, the highest growth since 1979.Very high oil export revenues pushed the current account surplus to an all-time high of $178.5 billion.

We estimate that a price of $66 per barrel for Saudi export crude (around $70 per barrel for Brent) and production of 9.6 million barrels per day are consistent with the revenue projection contained in the budget. We expect both revenues and expenditures to be above the budgeted level and forecast a budget surplus of SR177 billion (6.3 percent of GDP) based on oil price of $104 per barrel for Brent.



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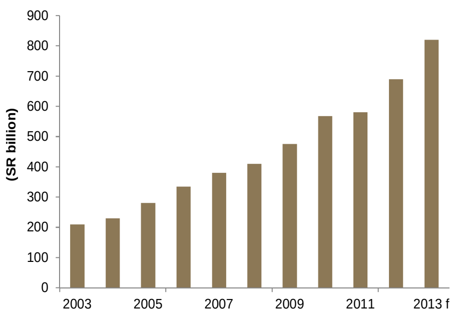
The 2013 budget

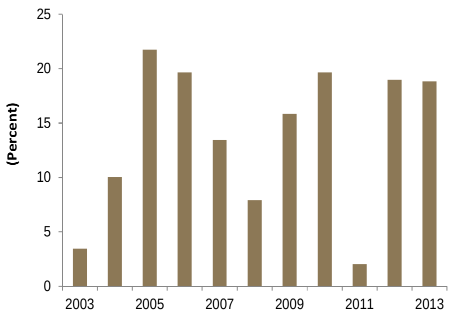
Budgeted spending is at another all-time high in 2013, as the government continues with its program to upgrade the human and physical infrastructure and spurring economic growth. One highlight of the Ministry of Finance (MoF) budget announcement is the 18 percent jump in revenues. With no new initiatives announced, we think this is a sign that the government has maintained the less conservative approach with its oil price assumption since last year. For the second consecutive year, the Kingdom has budgeted for a surplus which set to reach SR9 billion this year (0.3 percent of expected GDP). In the US and across Europe, countries are cutting spending to bring budget deficits under control and reduce their debt. This is not a concern for the Kingdom. While the planned surplus is small, debt is very low and should a deficit occur it can be financed comfortably by drawing on the vast stock of foreign assets rather than issuing new debt, we think.

Expenditure

Budgeted expenditure



Growth in budgeted expenditure



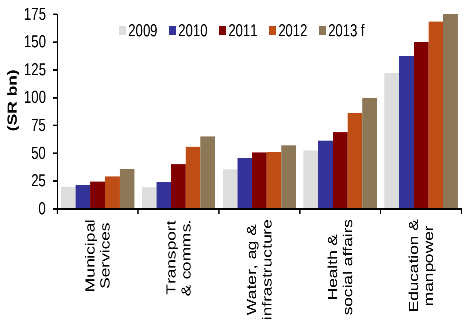
Total expenditure is budgeted at SR820 billion in 2013 .This is a SR130 billion increase on the figure budgeted for 2012, making it the highest nominal increase in budgeted spending for which data is available.

Budgeted spending is some way below the actual level in 2012 of SR853billion. We don't view this as withdrawal of the stimulus or a rethinking of the ongoing expansionary fiscal stance. In fact, actual spending as a share of non-oil GDP remains on the high side at 83.5%, compared with 70% of non-oil GDP in the last ten years. In addition, the government has consistently overrun its budgeted spending by an average of 24% over the past decade. The last year that budgeted spending was greater than actual spending in the previous year was 2000. That said, the difference between the level of expenditure budgeted for 2013 and the actual level of spending in 2012 was relatively small at 4 percent, compared to an average of 9 percent over the previous decade. In addition, part of the divergence can be explained by the temporary nature of some of the payments that affected the government budget in 2012 such as the unemployment benefits (SR30 billion), the one-time allocation for the Real Estate Development Fund and The Saudi Industrial Development Fund (SR19.5 billion).

The SR130 billion increase in overall budgeted spending was equally spelt between current and capital spending. Budgeted investment spending has been raised to SR285 billion compared with SR222.5 billion in last year's budget. Current spending expanded by 14 percent compared with last year's budget, and accounting for at least 65% of total spending. Current spending is also 85% higher than their level five years ago which highlights the risk of rising rigidity in the kingdom's budget. Wages and salaries are the largest component of this and are certain to be a major contributor to the higher spending. Operations and maintenance costs are also likely to be a growing source of current spending in future years as major projects become operational.

While budget expenditures in the 2013 budget spans all sectors the priorities are consistent with recent years. Education is allocated the biggest share of those departments disclosed in the budget, at 25 percent of total spending followed by the health and social affairs

Spending by sector



with 12.2 percent. Municipal services and education received the largest increase in their allocations, at 23 and 21 percent, respectively.

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

Education and training was allocated SR204 billion, a 21 percent increase on 2012 allocation, the highest increase since 2007. This will be used to finance work on 539 new schools and 1,900 existing school-construction projects as well as the necessary funds to refurbish 2,000 schools. The allocation also included 15 new colleges and further work to be undertaken on the construction of facilities at newly-opened universities. SR13.4 billion has been appropriated for an electronic university; no other new universities are planned. In addition, SR4.25 billion has been allocated to build three new college hospitals. Finally, SR21.6 billion has been allocated for the over 120,000 Saudi students studying abroad and their families.

Health and social affairs was awarded a 16 percent rise in its budget, to SR100 billion, accounting for 12.2 percent of total spending. New projects in this area will include construction on 19 new hospitals and healthcare centers, adding to the 102 already in progress. Social projects will include construction of 20 new sport club centers and 15 social and rehabilitation centers and social security offices at a cost of SR29 billion.

Water, agriculture and (related) infrastructure spending is budgeted at SR57 billion, an increase of 11 percent. Funds have been set aside for new silos projects, in addition to enhancing water and related utility services supply and improving the water and water treatment networks.

Transport and telecommunications received the third largest increase of any of the areas announced. Spending is budgeted to rise by 16 percent to SR65 billion. New projects in the transport sector include finishing work on existing road projects, finishing industrial cities' and Ras Al-Khair's infrastructure projects, in addition to new sea ports and construction of railways.

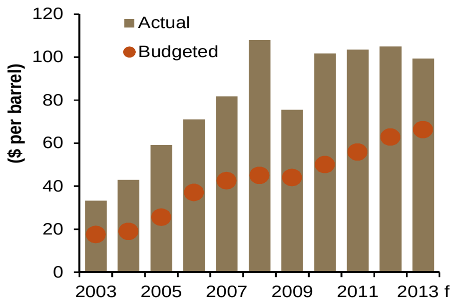
Municipality services were given a 23 percent increase in budget, the highest increase of any of the area announced. The total allocation thus increased to SR36 billion of which SR4bn will be financed from municipality services. The spending retains the same focus as previous years.

Although not disclosed in the budget announcement, it is likely that defense and security accounted for the largest component of government spending. According to Saudi Arabian Monetary Agency, defense and security spending accounted for 30.8 percent of the budgeted total in 2012, the lowest proportion since 1984. Several multi-billion dollar defense contracts have been signed in last few years and media reports of new agreements appear sporadically. These payments tend to be spread over many years, so the additional impact on spending in 2013 should not be too great.

Revenue

Total revenue is budgeted at SR829 billion. We anticipate that

Budgeted versus actual oil price
(Saudi export crude)



around 90 percent of total revenue will come from oil; an official revenue breakdown was not published. As is the norm, the oil price and production projections used to derive the revenue figure were not disclosed. We calculate that oil production of 9.6 million barrels per day at a price for Saudi export crude of $66 per barrel (equivalent to around $70 for Brent) and an oil export/revenue transfer ratio of 88 percent is consistent with the oil revenue projection in the current budget.

The government has consistently based its budget on a conservative oil price assumption. Over the last decade the actual oil price has averaged over 70 percent higher than the one used for the budget (for 2012, it is around 52 percent higher). The last year actual oil prices averaged below the budgeted level was 1998. Brent is currently trading at $110.6 per barrel, 58 percent above the level we estimate is used for the budget. Nonetheless, the price assumption in the current budget maintained the less conservative approach started in last year's budget. As a result, revenues are projected to rise by 18 percent compared with the previous year's budget. Even though we anticipate that both production and prices will be lower than in 2012 (see box), we think that revenues will be comfortably above the government's assumption and that using a more realistic oil price assumption is healthy. Revenues generally provide the base from which expenditure is calculated; unrealistically low oil revenue and spending assumptions have contributed to high levels of overspending in recent years.

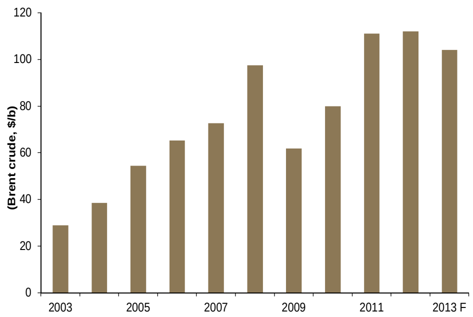
Jadwa's oil market outlook for 2013

Oil prices are forecast to fall in 2013 owing to a weakening of the global economy and further ease in global oil balance. We forecast that Saudi export crude will average $99.4 per barrel (equivalent to $104 per barrel for Brent). With output from Iraq and North America steadily rising, we expect Saudi oil production to fall by one percent to 9.6 million barrels per day.

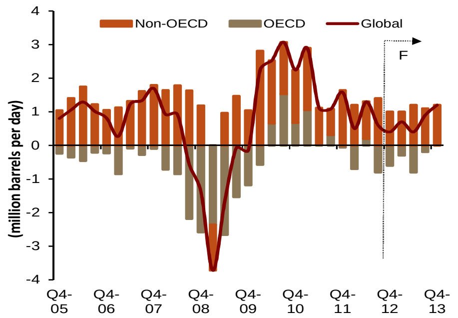
- Global oil demand is expected to rise in 2013 as a result of relatively sound performance in emerging markets. Oil demand growth in the non-OECD countries mainly driven by China, India and the Middle East is expected to outpace a fall in oil demand from the OECD region. According to the International Energy Agency (IEA), Asia alone will be the source of over 50 percent of global oil demand growth in 2013. Demand growth from elsewhere will remain subdued as economic growth recovers gradually. European oil demand expected to shrink by 0.2mbpd next year. A further deterioration in the Euro zone growth would weigh on oil prices.

- Total world oil output should also rise in 2013 despite higher disruption risks particularly among some of the Middle Eastern oil producers. While political unrest in Syria, Yemen, Sudan, South Sudan and sanctions on Iran will maintain the pressure on the oil market, the full return of Libyan oil production, the strong oil production growth coming from Iraq and North America will ease such pressure. All in all, non-OPEC supply is expected to rise by 0.9mbpd most of which is coming from North America according to the IEA. We expect OPEC to reduce its production marginally in 2013. The latter is mainly due to low Iranian oil production which is likely to remain at the current level

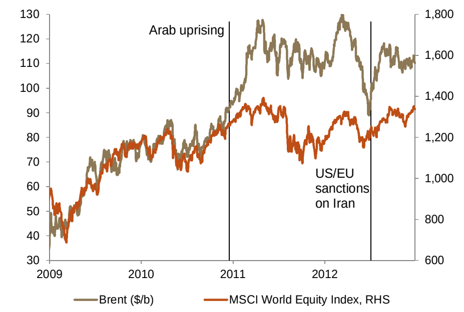
Oil prices
(period average)



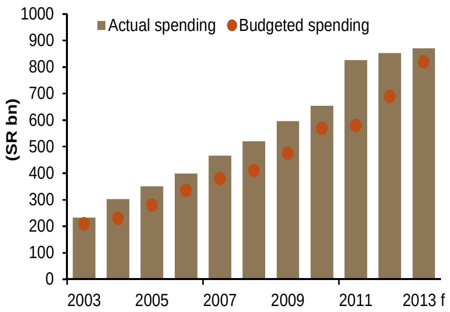
Change in global oil demand



Geopolitical development and oil price



Spending in excess of budgeted total



throughout next year with risk tilted to the downside. We also expect Saudi Arabia to slightly cut production to balance the market.

- The current high commercial oil stocks should pose negative element for oil prices. OECD crude stock levels remains at a comfortable level when measured in days of demand coverage as well as relative to their five-year average. This reflects a strong build in the last seven months.

Geopolitical risks and increased liquidity poured into the system from central banks also need to be considered when forecasting prices. The turbulence in the Middle East and North Africa added a risk premium to prices in 2012 and this will likely remain the case for most of next year as uncertainty is likely to linger. Tensions surrounding Iran have also the potential to cause oil prices to remain elevated.

Financial flows have also influenced oil prices in recent years. The US, Japan, and EU monetary easing measures have been supportive for oil prices, though the impact is relatively short lived as weak global fundamentals start making their negative impact on the market. In 2013, the prices could come under some pressure as uncertainty over Europe and US fiscal cliff affect sentiment.

Projections for non-oil revenues were not published. Fees and charges for government services and customs tariffs are the main sources of non-oil revenues. As we highlighted in our latest economic update, we anticipate receipts from both of these sources to rise as a result of solid economic performance. Although government foreign assets are at an all-time high, revenues earned from investment income are unlikely to rise too much because of the exceptionally 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 SR177 billion in 2013 ,equivalent to 6.3 percent of expected GDP. 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 SR1,048.5 billion and non-oil revenues at SR106 billion.

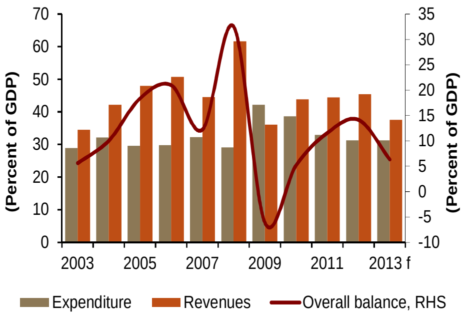
Spending will be above the budgeted level. Over the last ten years, actual government spending has averaged 24 percent higher than the budgeted amount. The extent of overspending is likely to be smaller than the previous two years. This is due to the fact that the temporary spending commitments contained in a series of Royal Decrees in 2011 are not likely to affect the 2013 budget. We thus expect that the excess spending in 2013 will be relatively close to the budget projection leading to a total expenditure of SR871 billion.

The oil price level necessary for revenues to balance our forecast level of government spending, known as the fiscal breakeven price, is $67 per barrel for Saudi export crude (equivalent to around $71 per barrel for Brent). This is based on our production assumption of

9.6 million barrels per day, domestic consumption of 2 million barrels per day and an oil export/revenue transfer ratio of 88 percent. Output from the Karan gas field, which is likely to reach full capacity next year, should take some of the burden from oil as the fuel for domestic energy consumption next year.

Budgetary performance in 2012

Budgetary performance



The recent announcement by the Ministry of Finance reveals that 2012 fiscal outturns were better than the 2012 budget's projections and slightly exceeded Jadwa's forecasts. At SR386 billion, the surplus was the second highest on record. It was the equivalent of 14.2 percent of GDP. Higher oil revenues, the result of around 7.4 percent in oil production (with exports around 7 percent higher) and elevated average oil price at $112 per barrel for Brent, were the reason for the larger surplus. Spending was well in excess of the budgeted projection, but this was outweighed by the increase in oil revenues.

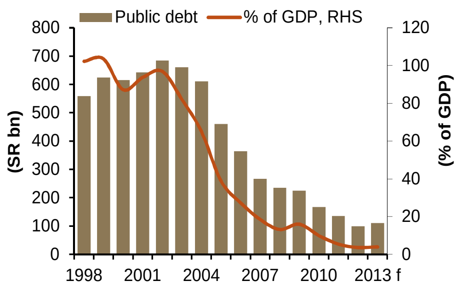
Revenue totaled SR1,239 billion (Jadwa: SR1,189 billion), breaking the previous year's record high. It was 76.5 percent above the budgeted level and 10.8 percent greater than their 2011 level, due to higher than budgeted oil prices and production. We estimated that the 2012 budget was based on a price for Saudi oil of $69 per barrel and production of 8.8 million barrels per day. With a few days of the year left, it seems likely that the actual price of Saudi oil will average $105 per barrel. Production will be around 9.9 million barrels per day, after it was raised to compensate for the shortfall from Iran and rising demand from emerging markets mainly from Asia. Non-oil revenues were SR99.1 billion, up around 18.8 percent on the 2011 total.

2012 Budget data
(SR billion)

	Budget	Actual	Difference
Revenues	702	1,239	537
Expenditures	690	853	163
Balance	12	386	374

Expenditure amounted to SR853 billion (Jadwa: SR841 billion), 23.6 percent above the budgeted level and 3.2 percent higher than in 2011. The annual increase in 2012 was, however, lower than that of last year (25 percent) as the effect of some of the temporary measures introduced in the first quarter of 2011 fades. Despite such moderate increase, the permanent measures of these packages particularly on wages and other allowances kept spending elevated in 2012. The actual spending is 83 percent higher than its level five years ago. A breakdown of spending into capital and current expenditure was not published. It is important to note that the initial estimates of government spending and revenues contained in the budget statement tend to be revised. Generally, both are increased, with the rise in spending usually larger than that for revenue.

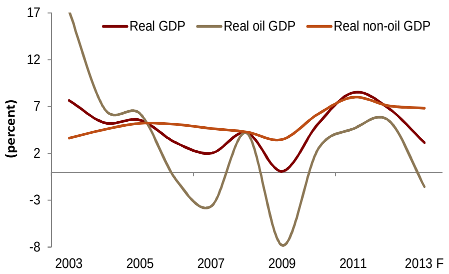
Government debt



Total outstanding government debt was projected to fall to SR98.8 billion by the end of 2012, equivalent to just 3.6 percent of GDP. Commercial bank holdings of government and quasi-government debt securities have fallen by SR2.2 billion over the first 11 months of this year. Bank holdings of longer-term government bonds are down by SR4.4 billion to SR43 billion, a record low for the period which data is available. The remaining government debt is held by the two government pension funds, the General Organization for Social Insurance 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 2012.

Economic performance in 2012

Real GDP growth
(year-on-year change)

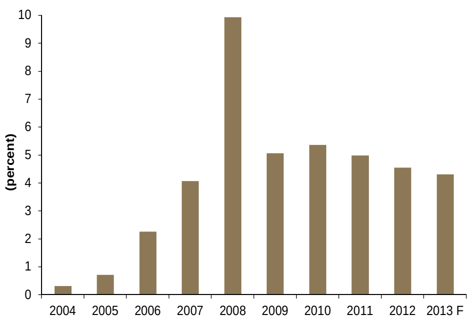


The Ministry of Finance budget announcement included preliminary macroeconomic data, which provide some insight into the government's view on economic performance in 2012 and prospects for 2013. This showed that economic performance was very strong. Non-oil economic growth was at 7.2 percent year-on-year one and half percentage point above our forecast. Non-oil private sector expanded by 7.5 percent compared with our forecasts of 6.1 percent. Nominal GDP expanded by 8.6 percent, despite rising oil production. Higher oil revenues contributed to higher current account surplus. Inflation declined.

Real GDP growth rose to 6.8 percent year-on-year. We had anticipated a jump in economic growth due to higher oil production, as the Kingdom increased oil production in 2012 to compensate for the decline in Iranian oil production output and to satisfy rising demand, especially from non-OECD countries. As a result the oil sector grew by 5.5 percent. The budget announcement also included another revision to 2011's growth rate which is now revised to 8.5 percent compared to 7 percent previously. The announcement, however, did not include the revised breakdown for the GDP components in 2011.

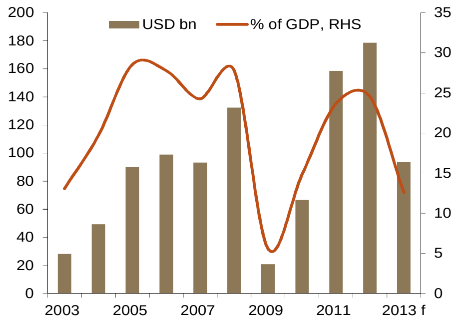
The **non-oil private sector** grew by 7.5 percent. We had anticipated an improvement in 2012 as high government spending lifted business and consumer confidence and banks' comfort in the lending environment despite another year of regional turbulence and growing concerns about the global economy. Some of the sectoral growth rates were way above what we had forecast. On annual basis, two sectors grew at double digit rates: transport and communications (10.7 percent) and construction (10.3 percent). While we had anticipated the construction growth to be the fastest growing sector in 2012, the growth rates of both the construction and the transport and communication sectors were 2 and 3 percentage points higher than our forecasts, respectively. Growth in other sectors was more in line with expectations, with retail at 8.3 percent, electricity, gas and water at 7.3 percent and finance at 4.4 percent.

Inflation
(year-on-year change)

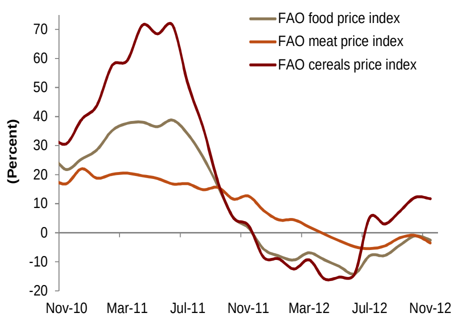


Inflation was put at an average of 4.5 percent, compared to 4.9 percent in 2011. There is a tendency for the inflation data to be presented in the budget to be out of line with that produced on a monthly basis by the Central Department of Statistics, but in 2012 the data is much closer. According to the Central Department of Statistics inflation averaged 4.6 percent over the first eleven months of 2012. The slight fall in inflation in 2012 was because of lower food price and a gradual decline in rental inflation in the second half of the year. The surge in consumer spending resulting from higher public sector wages and other labor market reform initiatives have fed into inflation, but given the extent of the spending, the rise in inflation from areas such as education and entertainment and transport and telecoms has been fairly modest. In fact, our measure of core inflation which excludes food and housing and related services has

Current account



International food prices
(year-on-year change)



slowed to 3 percent in the first eleven months of this year compared with 3.5 percent for the same period of last year. Another measure of inflation, the non-oil GDP deflator rose to 3.8 percent from 6.1 percent in 2011. The non-oil GDP deflator is only available on an annual basis, it 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** hit a new all-time high of $178.5 billion (SR669.2 billion), up from $158.5billion in 2011. 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). Higher oil prices and production raised oil export revenues to SR1,302billion, 88 percent of total export revenues. Non-oil exports rose by 4 percent, in line with our expectations as global demand for petrochemical product slowed during the year. Imports were up by 7 percent, broadly in line with the monthly trade data. Data for the first ten months of 2011 show that imports of machines and equipment and transport are well up on 2012. Data on the other components of the current account was not published.

The economic outlook for 2013

We expect 2013 to maintain the solid growth momentum albeit at slower pace. While overall economic growth will slow, this will be due to lower oil production. Greater execution of government investment projects, especially in the infrastructure sector, means that non-oil growth should maintain the current solid performance. Bank lending will remain supportive and regional unrest will be less of a drag on domestic performance. Inflation should be down a little as domestic spending pressures recede and external pressures stay subdued, though the risks are on the upside given the outlook for the US dollar. Oil prices are expected to slightly fall as the weak global economy puts pressure on oil demand and rising output from Iraq and North America boosts supply.

Economic growth in Saudi Arabia is forecast to fall to 3.1 percent in 2013, owing to lower oil production and large base-effect for the non-oil sector. High government spending will continue to be the engine of the non-oil economy, supported by greater bank lending and healthy domestic consumption demand. Within the non-oil sector, we expect the government's real GDP to expand 4.9 percent year-on-year due to higher capital spending, while the non-oil private sector is expected to expand by 7.8 percent. In particular, we expect utilities, construction, transportation and retail, the main beneficiaries of government spending, to be the fastest growing sectors of the economy.

Inflation is expected to slightly fall to an average of 4.4 percent with rent and food prices the main contributors. External pressure on domestic prices is likely to remain weak particularly as international food inflation remained subdued. The housing inflationary pressures component is likely to continue to be the main contributor to overall inflation, but gradually slowing down as housing supply bottlenecks start to dissipate. In fact, it has been decreasing in recent months despite higher consumer disposable income, which should mean that the drop will not be large. We think there will be some local inflationary pressure as a result of the high level of consumer and government spending. We do not foresee any changes to the riyal's peg to the dollar. Lower oil revenues will cause the current account surplus to ease, though it will remain substantial, at over 12.6 percent of GDP.

2012 results and 2013 Jadwa forecasts

	2012 Actual	2013 Jadwa Forecast
Real GDP (% change)	6.8	3.1
Nominal GDP (% change)	8.6	2.2
Inflation (1999 =100, %)	4.5	4.4
Current account balance (SR billion)	669.2	351

While the economic picture will improve, 2013 will be the fifth consecutive year that economic growth will be heavily dependent on government spending. This spending will be affordable, but the economic growth such vast spending will generate will not be spectacular. The downside risks to our growth forecast stem from a deeper European recession, fiscal concerns weighing on the US growth outlook and its consequences on both advanced and emerging economies, all of which could reduce global oil demand resulting further drop in the oil sector growth and subsequent negative spillovers on the non-oil sector.