25 December 2014

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Saudi Arabia's 2015 Budget Report

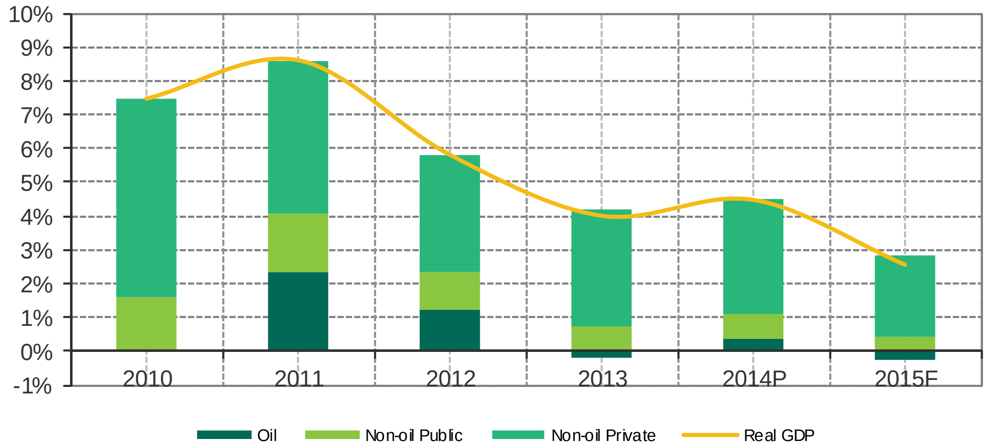
Stable Future on Prudent Past Policies

Contents

Highlights and NCB Views

On Thursday, 25 December 2014, the Council of Ministers endorsed the government's budget for 2015 and announced the final outcome of fiscal operations and macroeconomic performance for 2014. The highlights are:

- The fiscal balance recorded the first deficit since 2009 at SAR54 billion in 2014, approximately 1.9% of GDP, affected by lower oil revenues and increased expenditures.
- Based on 2010 prices, the Saudi economy accelerated by 3.6% during 2014, outperforming 2013's growth of 2.7%. Ostensibly, the non-oil sector underpinned the economy by growing around 5.2%.
- Importantly, the non-oil private sector increased by 5.7% Y/Y, driven by construction, trade, and manufacturing that grew by 6.7%, 6.0% and 6.5%, respectively.
- The 2015 budget estimates revenues at SAR715 billion and expenditures at SAR860 billion, projecting the first deficit since 2009. The budget continued to emphasize both human and physical capital expenditures to support sustainable and balanced growth.
- We project total revenues at SAR848 billion and expenditures at SAR996 billion, predicting a deficit of SAR147 billion in 2015. Our forecast is based on an average Arabian light oil price of USD80/bbl for 2015.
- The next five years might prove to be a challenging time for policy making. Range-bound crude oil prices between USD70-100/bbl might materialize during the medium-term horizon, which will weigh negatively on oil revenues and will reverse the hefty fiscal and current account surpluses of recent years.
- In 2015, we project real GDP growth of 3.4%. The contraction in the oil sector, given an expected reduction in crude production by around 200 thousand b/d will largely be offset by the non-oil private sector, which is estimated to grow by 4.0%, driven by the private sector, mainly construction, trade and manufacturing.



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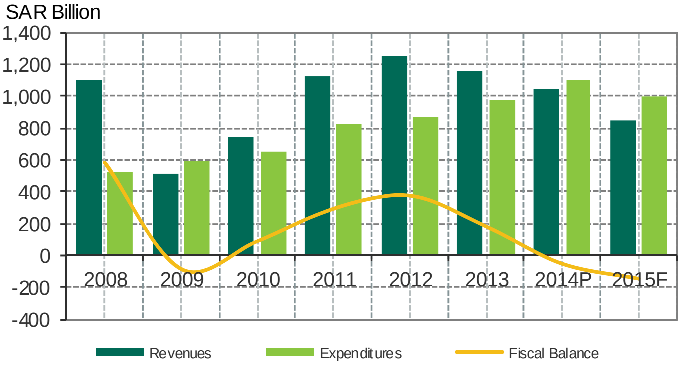
Macroeconomic Indicators	2011	2012	2013	2014P	2015F	Latest	Date
Real Sector							
Average Arab Light Spot (USD/bbl)	108	110	106	102.0	80.0	100.6	11M14
Average Saudi Crude Oil Production (mbd)	9.3	9.8	9.6	9.7	9.5	9.7	11M14
GDP at Current Market Prices (SAR billion)	2511	2752	2589	2821.7	2662.6	-	-
GDP at Current Market Prices (USD billion)	670	735	691	753.5	711.0	-	-
Real GDP Growth Rate, %	8.6%	5.8%	4.0%	3.6%	3.4%	-	-
CPI Inflation (Y/Y % Change, Average)	3.7%	2.9%	3.5%	2.7%	2.5%	2.5%	Nov-14
External Sector							
Trade Balance (USD billion)	245	247	221	211	129	-	-
Current Account Balance (USD billion)	159	165	133	107	36	-	-
Current Account/GDP	24%	22%	19%	14.1%	5.1%	-	-
Net Foreign Assets with SAMA (USD billion)	536	648	718	710	678	733	Nov-14
Fiscal Sector							
Actual Revenues (SAR billion)	1,118	1,247	1,156	1046	848	-	-
Actual Expenditure (SAR billion)	827	873	976	1100	996	-	-
Overall Budget Balance (SAR billion)	291	374	180	-54	-147	-	-
Budget Balance/GDP	12%	14%	7%	-1.9%	-5.5%	-	-
Break-Even Oil Price (USD/bbl)	75.3	73.9	82.6	96.2	89.7	-	-
Financial Sector							
SAR/USD Exchange Rate	3.75	3.75	3.75	3.75	3.75	3.75	Nov-14
Growth in Broad Money (M3)	13.3%	13.9%	10.9%	12.1%	10.4%	12.3%	Nov-14
Growth in Credit to the Private Sector	11.0%	16.4%	12.1%	12.1%	8.4%	12.2%	Nov-14
Average 3M SAR Deposit Rate	0.7%	0.9%	1.0%	1.0%	1.0%	1.0%	11M14

Source: Reuters, SAMA and NCB

I. Macroeconomic and Fiscal Performance in 2014

The budget balance recorded the first deficit since 2009. Revenues remained above the SAR1 trillion mark, reaching SAR1'046 billion, yet the decline in oil prices during 2H2014 acted as a drag even though crude production was elevated around 9.7 MMBD. Expenditures continued their expansive nature to reach a record SAR1'100 billion, which equates to a deficit of SAR54 billion, compared to an average surplus of SAR281.8 billion over the past three years. Nonetheless, the government has expressed commitment in guiding the economy towards a sustainable positive trajectory.

Figure (1): Fiscal Balance

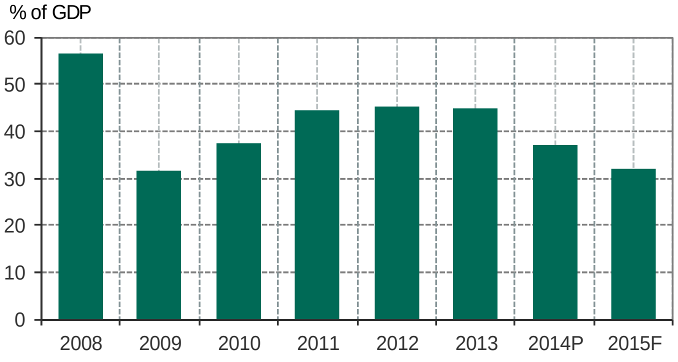


Sources: MOF, SAMA and NCB

The landslide in oil prices slowed down fiscal revenues in 2014. Oil revenues declined by 10.1% to SAR931 billion on the back of an 8.3% decline in Arabian Light prices that averaged USD99.0/bbl YTD. The oil story was one of two halves that exhibited the inherent volatility in oil markets, with Arabian light spot prices averaging USD107.5/bbl in 1H and then nose-diving in 2H to dip below USD60/bbl for the first time since 2009. In contrast, production levels remained stable, averaging 9.69 MMBD in 2014YTD, an insignificant increase above last year's 9.64 MMBD.

The Kingdom's expense bill surpassed SAR1 trillion threshold, a record high. Actual expenditures are estimated at SAR1'100 billion, representing a 28.7% increase above budget and 12.7% higher than actual expenditures in 2013. The Kingdom represents the largest megaprojects market in the region, evident from SAR184 billion in new projects in addition to outlays for on-going projects that according to our estimates will bring the total amount spent on capital expenditures closer to SAR352 billion. Meanwhile, additional capital expenditures amounting to SAR22 billion have been financed from the Budget Surplus Fund. Even though we still believe that restraining growth in current expenditures is highly needed to mitigate fiscal sustainability concerns, the success of the recent Saudization drive will be favorable budget-wise especially that it can contain the need for public sector employment as well as the rise in allocations for unemployment (Hafiz) and social benefits. The extensive Saudization efforts have added 622 thousand new jobs in the private sector during 2011-2013, a staggering 74% gain, and the number is bound to rise further this year to bring Saudis' participation close to the 2 million mark.

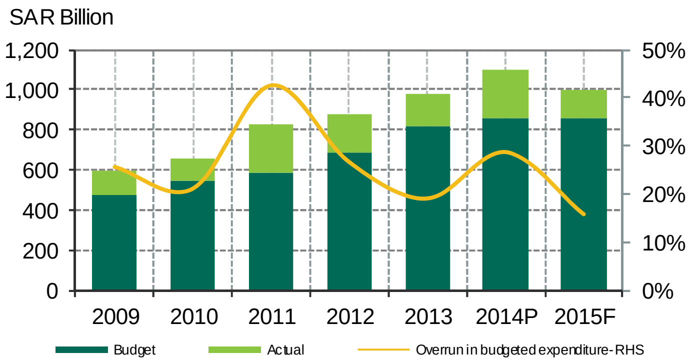
Figure (2): Fiscal Revenues in % of GDP



Sources: MOF, SAMA and NCB

Saudi remains a net lender to the rest of the world as the current account balance attained another surplus. Yet, the surplus registered a 19.8% decrease compared to 2013 to settle at USD106.5 billion, 14.1% of GDP, due to lower oil export revenues. Saudi's imports marginally decreased by 2.6% to reach USD150.6 billion as global prices declined which reduced the bill on domestic consumption. Obviously, a stronger dollar and weakening global commodity prices have contained the import bill. Meanwhile, total Saudi exports contracted on the back of lower oil prices towards the end of the year to bring the trade balance to USD210.6 billion for 2014. In addition, over 11M2014, net foreign assets with SAMA have increased to USD733.2 billion from USD717.7 billion at the end of 2013, leaving official foreign reserves at a very healthy position covering more than 56.6 months of imports, near record highs. SAMA's net foreign assets are expected to decrease as the government begin to utilize these built up reserves to cover fiscal deficits, a situation that has recently materialized with net foreign assets registering the first three monthly declines since May, June, July 2009.

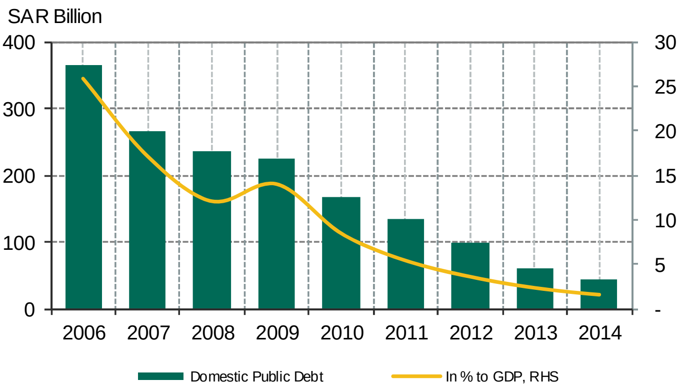
Figure (3): Budgetary Overruns



Sources: MOF, SAMA and NCB

The Kingdom's domestic debt continues to reflect a strong and healthy economy as it reached SAR44.1 billion, 1.6% relative to GDP. Even though the government is able to pay off the entirety of its debt, it opted 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. The result of Saudi's policy decisions have been reaffirmed by Fitch as they upgraded the economy from AA- to AA with a stable outlook for the Kingdom. SAMA continues to use various tools to implement its prudent policies such as issuing T-bills to control liquidity. The pace of issuances have increased this year by 32.7% Y/Y for 11M2014 as T-bills reached SAR224.6 billion by November.

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



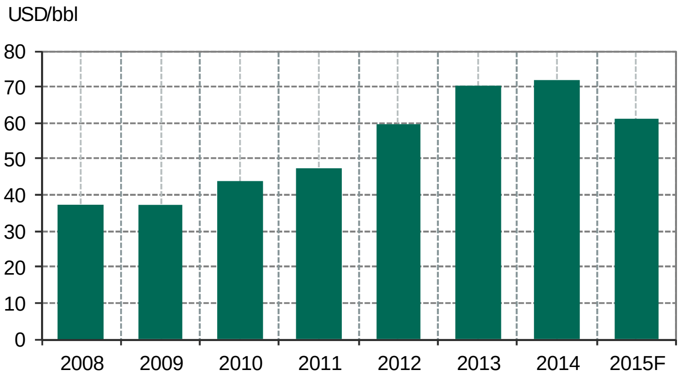
Sources: MOF and SAMA

II. Fiscal Budget Outlook in 2015: Stable Future on Prudent Past

The government is adamant in pursuing expansionary policy to diversify the economy and ensure sustainable growth. The 2015'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 25.2% of total allocations, with health accounting for 18.6% of the budget. The 2015 budget release estimates revenues and expenditures at SAR715 billion and SAR860 billion, respectively, projecting another deficit for 2015 as suppressed oil markets pressure the Kingdom's balances. Based on previous years, we believe that these figures are underestimated, and the government will overrun the budget and record a larger deficit on the back of higher current expenditures, notably for wages and salaries, and continued funding for megaprojects. However, in our opinion the actual expenditures growth will fall into negative territory, well below the 13% average registered during 2003-2013 as the government uses its huge foreign reserves prudently.

Oil prices will be the main drag on Saudi's balances. 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 USD61/bbl. With our forecast of USD80/bbl for the Arabian light spot price average and a 9.5 MMBD for oil production average in 2015, we project revenues and expenditures at SAR848 billion and SAR996 billion, respectively. This would lead to a budget deficit of SAR147 billion, or 5.5% of estimated GDP in 2015.

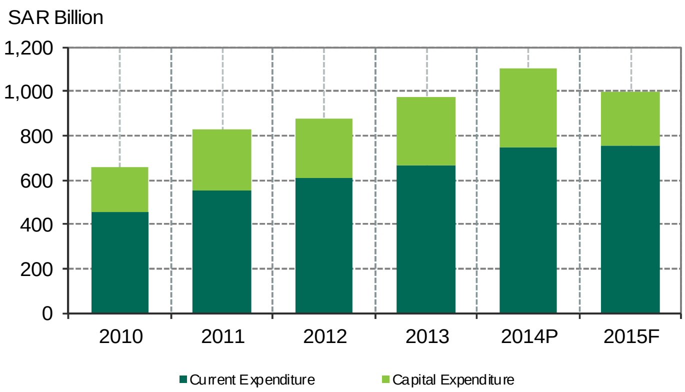
Figure (5): Implicit Budget Oil Price



Sources: NCB

Actual current expenditures are expected to overrun budget figures due to employee compensation. A budget overrun of 15.8% is expected for 2015 as total expenditures is forecasted to reach SAR996 billion, SAR136 billion over budget. Out of the budgeted SAR860 billion, around SAR675 billion or 78.5% is allocated to current expenditures, largely to pay for wages and salaries, which are going to rise due to a 13th-month pay that will be awarded based on the lunar calendar. The remaining SAR185 billion is allocated to capital expenditures, representing around 25% decrease compared to 2014. As Saudi continues with its infrastructure projects such as the Haramain Railway and the Grand Mosque expansions, CAPEX in 2015 is expected to reach SAR239 billion, decreasing by 32% over 2014.

Figure (6): Actual Expenditures



Sources: MOF, SAMA and NCB

The government continues to allocate funds to specialized credit institutions to support balanced development. Based on the announcement, around SAR73.7 billion in 2015 will be disbursed by specialized credit institutions to finance industrial projects and to support social development, thus, complementing private credit growth that recorded 12.2%Y/Y in November 2014. A case in point is the Ma'aden's project for Wa'ad Al-Shamal phosphate mine, whereby Public Investment Fund (PIF) is extending a loan worth SAR2 billion. The Saudi Industrial Development Fund (SIDF) has approved 185 loans last year, valued at SAR8.3 billion across 8 promising industrial areas. During the first three quarters of this year, the Saudi Credit and Saving Bank has financed 1,630 SMEs, granting more than SAR394 million under the "Masarat" program. Additional measures of finance for SMEs continue to gain ground, with the Loan Guarantee Program "Kafala" facilitating credit worth around SAR1.6 billion by the end of 2Q 2014 to 1'800 establishments, representing 19.9% of the aggregate beneficiaries since the inception of the program in January 2006.

A stronger dollar, weak oil demand and a supply glut are projected to bring Brent and Arabian Light prices down to an average of USD80/bbl during 2015. The demand for oil will continue to be negatively impacted by global economic growth that petered out unexpectedly since the beginning of this year, with the IMF in early October reducing its forecast for global growth in 2015 to 3.8%, down from a July prediction of 4%. The uncertain economic outlook for China and the Eurozone that can result in negative spillover effects on the global economy remain a hanging cloud on world markets, especially that China is expected to grow at the slowest pace since 1990 and the Eurozone could be entering its third recession since 2008. In December, the IEA highlighted weakness in oil demand growth, cutting its global demand forecast for 4th time in five-months, in addition to OPEC that forecasted a reduced demand for its crude to 28.9MMBD in 2015, the lowest since 2003. On the supply side, US oil production supported by shale oil soared to a new 30-year high, 9.1MMBD with no signs yet that lower prices has slowed down drilling programs. Interestingly, oil rigs count in the US reached a record 1'609 in October, rising from just 179 in 2009. Additionally, OPEC had been producing above the 30MMBD quota for the last five months and after November 27th meeting it looks certain that a major production cut and/or increased compliance will be difficult to attain given all the competing interests within the 12-nation group. Looking ahead, Saudi Arabia's production is expected to remain elevated around 9.5 MMBD given the adamancy to maintain market share.

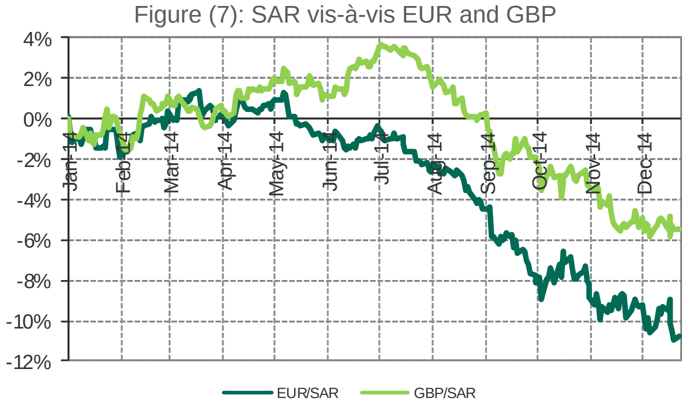
The decline in oil prices will cause the Kingdom to register a fiscal deficit for 2015. Our assumptions at an average of USD80/bbl will be the definitive factor in Saudi's expected SAR147 billion deficit, 5.5% of GDP. Oil revenues are likely to drop to SAR732 billion, declining by 21.4% compared to 2014, taking into account a stable export volume that is forecasted to shrink by a marginal 4.4% next year. Meanwhile, non-oil revenues will remain supportive at SAR116 billion, marginally above actual levels of 2014. Actual expenditures will likely exceed budgeted expenditures by 15.8% to reach SAR996 billion.

(SAR billion)	2014 Actual	2015 Budget	2015 Forecast
Total Revenue	**1,046**	**715**	**848**
Oil	931	601	732
Non-Oil	115	114	116
Total Expenditure	**1,100**	**860**	**996**
Current	748	675	757
Capital	352	185	239
Deficit/Surplus	**(54)**	**(145)**	**(147)**

Sources: MOF and NCB

The ongoing trend of a stronger dollar and lower commodity prices will put a lid on headline inflation rate, which will remain below 3%, averaging 2.5% in 2015. In 2014, prices edged lower, averaging 2.7% due to lower food prices. Local food prices averaged 3.4% Y/Y in 2014, significantly lower than 5.8% Y/Y registered in 2013. The steep decline in global food prices witnessed since early May, with the S&P Goldman Sachs Agriculture Index falling by 5.5% year-to-date, had softened domestic prices in the second half of 2014. Additionally, a strengthening greenback that have been appreciating across the board, with the trade-weighted dollar gaining around 11% year-to-date, have undermined the attractiveness of commodities as a hedge against inflation. On the rental component, prices maintained the same pace witnessed during 2013, albeit low compared to the 2007-2011 period by averaging 3.6% in 2014. In our opinion, the abovementioned dynamics will continue well into 2015 and as such it is expected that food and rent will both remain contained under 4%, especially with the recent moderation in domestic economic activities.

Figure (7): SAR vis-à-vis EUR and GBP



Sources: Reuters and NCB

III. Concluding Remarks

The Kingdom might have decoupled from the rest of the world during the financial crisis whether it be on the macroeconomic or the banking front. However, the next five years might prove to be a challenging time for policy making. Range-bound crude oil prices between USD70-100/bbl might materialize during the medium-term horizon, which will weigh negatively on oil revenues and will reverse the hefty fiscal and current account surpluses of recent years. The higher budget break-even oil prices will make the government more prudent and conservative. Nevertheless, the substantial net foreign assets and the unutilized debt capacity will act as countercyclical buffers that smooth out the business cycle if it surprised to the downside, an unlikely scenario, given the resilience of the corporate sector.

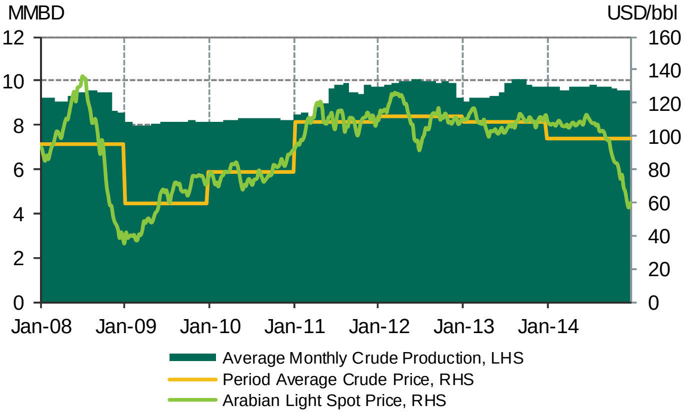
The abovementioned sluggish contribution by the oil sector will be offset by non-oil GDP growth that is expected to average around 4.3% during 2015-2019, as most sectors, mainly manufacturing and construction, continue to reap the benefits of the myriad projects still coming on-stream from the 2008-2013's SAR1.2 trillion capital expenditures boom. Yet, the relative deceleration compared to 2003-2013 time-frame will be attributed to the petrochemical sector that follows similar oil dynamics and an expected slower pace of increase in government expenditures. Since the Royal decrees announced in 2011, the annual growth in government expenditures had fell from a staggering 26.4% to 12.7% coupled by a similar reduction in the budget overrun from 42.5% to 28.7%, in 2011 and 2014, respectively. Hence, it is believed that government expenditures will plateau, resulting in a relatively lower direct and indirect stimuli. As mentioned earlier, we expect moderation in actual expenditures going forward.

In 2015, we project real GDP growth of 3.4%. The contraction in the oil sector, given an expected reduction in crude production by around 200 thousand b/d will largely be offset by the non-oil private sector, which is estimated to grow by 4.0%, driven by the private sector, mainly construction, trade and manufacturing.

Annex I: Macroeconomic Update

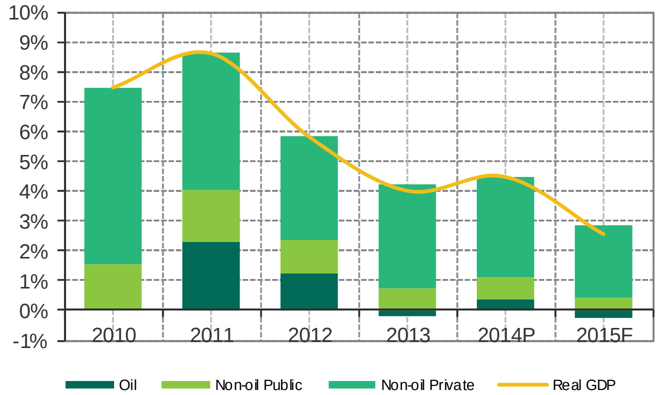
1. Crude oil prices declined from an average of USD106/bbl in 2013 to USD99/bbl in 2014YTD while Saudi crude oil production marginally rose from 9.64 million b/d in 2013 to 9.69 million b/d in 2014YTD.

Figure (1): Crude Oil Prices and Production



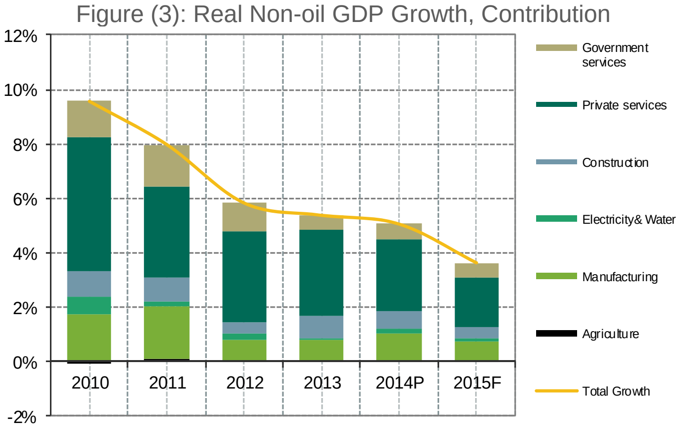
2. Accordingly, 1999 prices reflect a moderation, yet real GDP accelerated to 3.6% in 2014 from 2.7% in 2013 based on 2010 prices.

Figure (2): Real GDP Growth Contribution



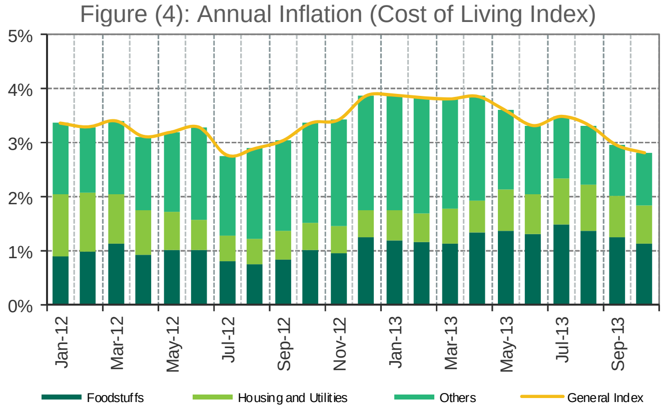
3. Non-oil private GDP continued to support the overall economy, expanding 5.7% in 2014, particularly in construction, trade and manufacturing.

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



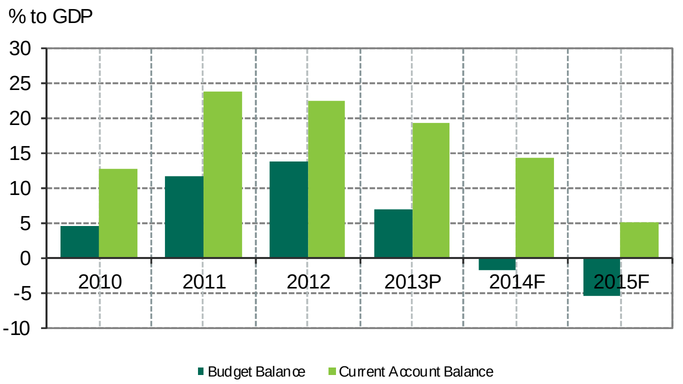
4. Inflation edged lower from 3.5% in 2013 to an average of 2.7% in 2014YTD, on the back of lower imported inflation and contained rental prices.

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



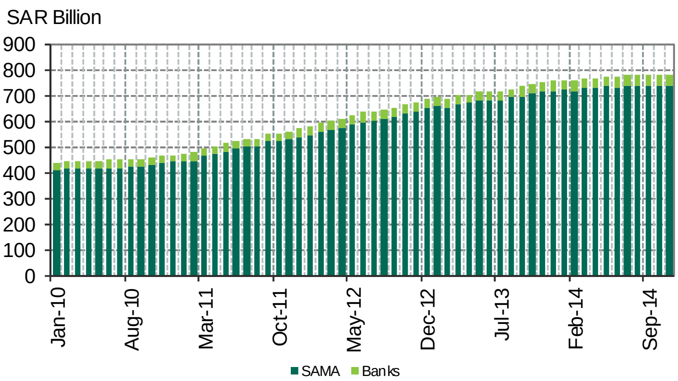
5. The external remained in surplus at 14.1% while the fiscal balance contracted to negative 1.9% of GDP in 2014.

Figure (5): Twin Surpluses



6. As such, net foreign assets have grown to USD733.2 billion in November from USD717.7 billion in 2013.

Figure (6): Net Foreign Assets



Sources: MOF, SAMA, Reuters and NCB

Annex 2: 2015 Budget and Announced Budgetary Allocations by Sector/Institution

The 2015 budget estimates total revenues at SAR715 billion and total expenditures at SAR860 billion, a deficit of SAR145 billion. Out of the SAR860 billion budgeted expenditures, total capital expenditures represent approximately 21.5%, 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 expenditures 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 SAR217 billion (25.2% of total), 3.3% higher than the amount budgeted for last year. As the largest recipient of budget allocations, projects include 3 new universities, renovation of 500 schools, and maintaining the SAR280 billion projects currently underway. 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 SAR160 billion (18.6% of total), over 48% over the amount budgeted in 2015. New projects include primary healthcare centers, 3 new hospitals, and completing the construction work of 117 hospitals and a number of social centers and welfare offices. The budget also includes appropriations for poverty reduction programs.
Municipality Services	Expenditures are projected at SAR40 billion (4.7% of total), an increase of 2.6% over the budget in 2015. 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 SAR63 billion (7.3% of total), which is 5.4% lower than the amount budgeted for last year. New projects include 2,000 km of roads, along with feasibility studies and design for the existing roads network. The allocation will also be directed towards new projects and expansions that will be disbursed across ports, railways, postal services and various industrial cities.
Water, Agriculture and Manufacturing	Expenditures are projected at SAR60 billion (7.0% of total), down by 1.6% over the amount in the 2015 budget. The budget includes appropriations to enhance water resources, as well as to improve water and sewage networks.

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