

2008 Budget

Fiscal Policy is Prudently Expansionary, Investment Friendly

12 December 2007

Highlights and NCB Views

- On 10 December 2007, the Saudi Ministry of Finance (MOF) announced the final outcome of fiscal operations in 2007, overviews of macroeconomic performance in 2007 and the budget of 2008. The actual fiscal surplus in 2007 stood at SAR178.5, which is lower than the SAR289.7 billion surplus attained in 2006. In line with our expectations, crude oil production cuts put a damper on real GDP growth rate, which decelerated further to 3.5% in 2007, down from 4.3% in 2006.
- Budgeted expenditures in 2008 came in at SAR410 billion, only 8% higher than budgeted expenditures in 2007, whereas budgeted revenues were projected at SAR450 billion, a larger nominal increase compared to 2007 estimated revenues. However, in real terms, after adjusting for the rising costs of construction materials and nominal effective (NEER) depreciation, growth in budgeted expenditures is likely to be slightly lower than the headline figure.
- Nonetheless, the indirect expansionary impacts of the 2008 budget are deemed to be far more important than the direct impact. The MOF budget release noted that after using SAR100 billion of the surplus to build reserves, the remaining will be used to settle the SAR53.5 billion of domestic public debt, and inject SAR25 billion over five years in the Real Estate Development Fund.
- In fact, the greater focus of the budget on capital expenditure, debt retirement and reserve accumulation whilst simultaneously providing more resources to the private sector is highly commendable at this stage of the cycle. Although non-oil private sector investment has so far lagged government investment, this trend will likely reverse aggressively over the medium-term, as the private sector benefits from major government initiatives and spending.

Macroeconomic Indicators

	2004	2005	2006	2007A	2007F	Latest	Date
Real Sector							
Average Saudi Light Crude, USD/BBL	33.9	49.3	60.3	-	63.0	64.2	10M07
Average Daily Crude Oil Production, MMBD	8.9	9.4	9.1	-	8.9	8.6	10M07
GDP at Current Market Prices, SAR billion	938.8	1,182.5	1,307.5	1,414.0	1,380.5	-	-
Real GDP Growth Rate	5.3%	6.1%	4.3%	3.5%	3.6%	-	-
CPI Inflation, Y/Y % Change, End of Period	0.6%	0.7%	2.2%	3.1%	3.5%	4.9%	Sep-07
External Sector							
Current Account Balance, SAR billion	194.7	337.5	357.7	344.4	309.4	-	-
Current Account Balance/GDP	20.7%	28.5%	27.4%	24.4%	22.4%	-	-
Net Foreign Assets in the Banking System, SAR billion	47.1	26.4	70.6	-	-	1,080.0	Oct-07
Fiscal Sector							
Revenues, SAR billion	392.3	564.3	655.0	621.5	675.1	-	-
Expenditures, SAR billion	285.2	346.5	390.0	443.0	416.9	-	-
Fiscal Balance, SAR billion	107.1	217.8	265.0	178.5	258.2	-	-
Fiscal Balance/GDP	11.4%	18.4%	20.3%	12.6%	18.7%	-	-
Monetary Sector							
Growth in Broad Money (M3)	20.4%	12.3%	19.3%	-	14.0%	21.1%	Oct-07
Growth in Credit to the Private Sector	37.0%	38.9%	9.8%	-	10.1%	17.8%	Oct-07
Average 3M SAR Deposit Rate	1.73%	3.75%	5.02%	-	-	4.9%	11M07

F/ NCB Forecast, A/ MOF Advance estimates

Head of Research

Dr. Said A. Al Shaikh
Editor/Chief Economist
s.alshaikh@alahli.com

Prepared By:

Perihan Al-Husseini
Economist
p.alhusseini@alahli.com

Muhammad Y. Malick
Senior Economist
y.malick@alahli.com

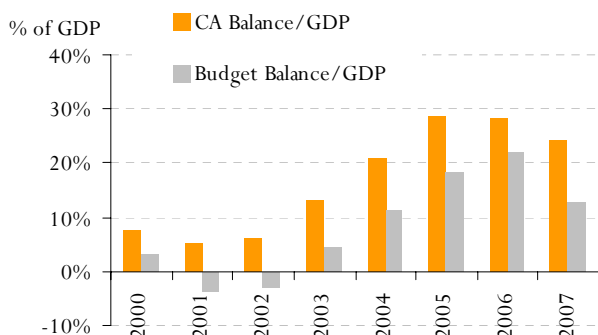
Mazen A. Tammar
Senior Economist
m.tammar@alahli.com

Majed Al Ghalib
MIS Specialist
m.alghalib@alahli.com

I. Macroeconomic Performance in 2007

Saudi Arabia's fiscal surplus to GDP ratio was only 12.6% in 2007, a marked decline from the 22.2% record in 2006. According to the announcement, fiscal revenues have declined by 8% to SAR621.5 billion, while expenditures increased by 13% to SAR443 billion in 2007. The current account surplus, which is partially a reflection of public savings, stood at SAR344.4 billion (USD91.8 billion) in 2007, approximately 24.4% of nominal GDP. Chart 1 below depicts the evolution of the twin balances of Saudi Arabia from 2000 until 2007.

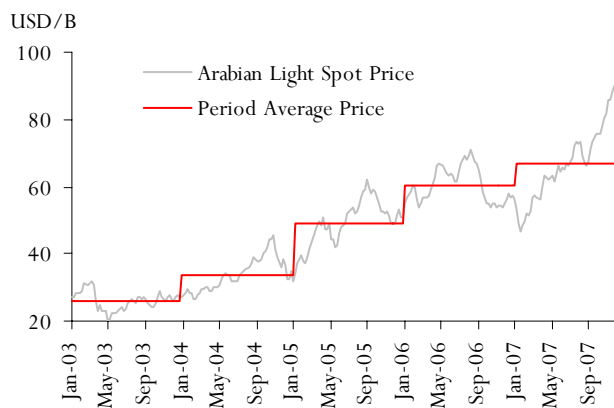
Chart 1: Twin Balances of KSA



Sources: SAMA and NCB

High average crude oil prices in 2007 were instrumental in fuelling the twin surpluses. The average Saudi Light spot crude oil price in 2007YTD was 11% higher than average 2006 prices. Accordingly, fiscal revenues soared to SAR621.5 billion, or approximately 44% of nominal GDP.

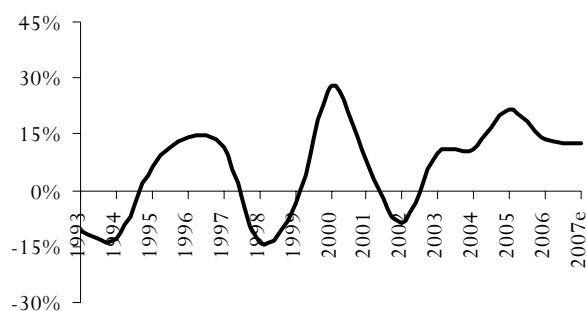
Chart 2: Saudi Light Crude Spot Price



Sources: EIA and NCB

Growth in actual expenditures remained stable at around 13%. In 2007, actual expenditures stood at SAR443 billion, compared to budgeted expenditures of SAR380 billion and actual 2006 expenditures of SAR393 billion. Interestingly, the government has maintained a semi-steady rate of growth of 14-15% in actual expenditures since the beginning of the current cycle, in contrast to erratic policy shifts during the 1990s. We believe this is a sign of a structural shift in fiscal policy from short-lived stimulus packages to a longer-term sustainability framework.

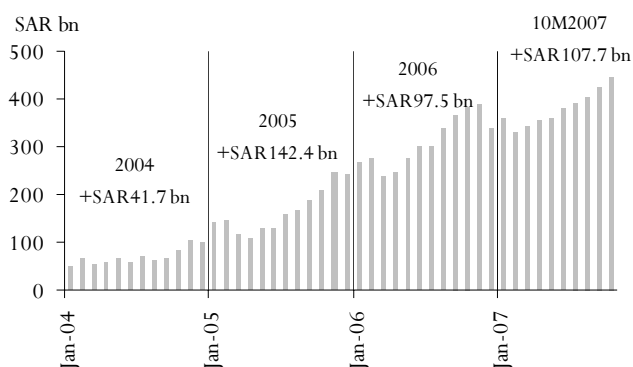
Chart 3: Annual Growth in Actual Expenditures



Sources: SAMA and NCB

Soaring petrodollar inflows have been prudently expended so far. Fiscal prudence has been partially evident in the sustained increase in the stock of government deposits in SAMA. From January 2004 until October 2007, these deposits surged from SAR52 billion to SAR446 billion, as depicted in Chart 4 below. It is worth mentioning that fiscal prudence and the accumulation of government deposits, mainly in the form of net foreign assets managed by SAMA, underpinned the decisions of S&P to upgrade the sovereign credit rating of Saudi Arabia to AA- in 2007.

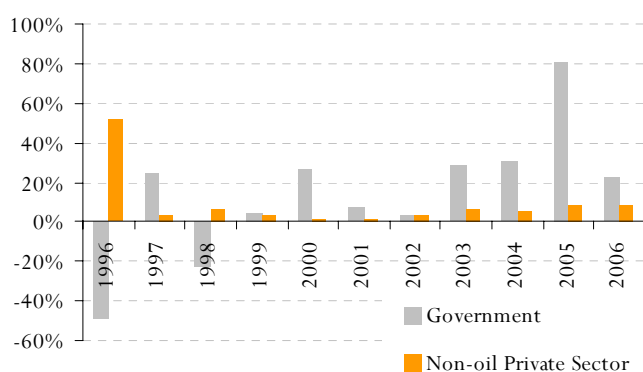
Chart 4: Government Deposits in SAMA



Sources: SAMA and NCB

Nonetheless, the government has so far bore the brunt of fuelling investment demand, evidently to crowd in private investment over the medium-term. As shown in Chart 5 below, the annual growth in central government investment expenditures has by far outpaced the growth in private sector investment since the beginning of the current oil cycle and up to 2006. Later in the report, we will see that this asymmetric growth in investment demand perfectly explains the hidden dynamics of the 2008 budget.

Chart 5: Annual Growth Rate in Government and Private Sector Investments

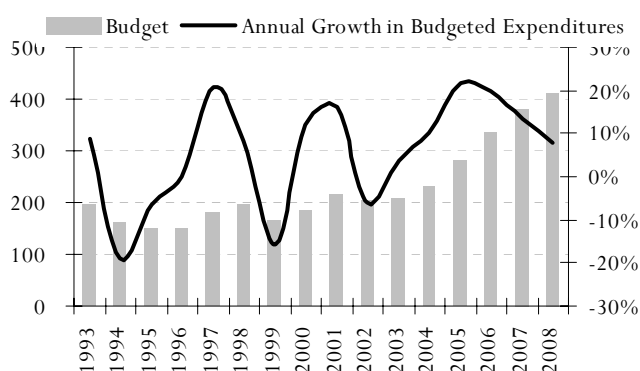


Sources: SAMA and NCB

II. 2008 Budget: Indirect Fiscal Stimulus Gaining High Weight

Budgeted expenditures in 2008 was only 8% higher than the 2007 budget. In nominal terms, the government earmarked SAR410 billion for 2007 expenditures, out of which SAR165 billion (40%) are allocated for capital expenditures. As depicted in Chart 6 below, growth in nominal budgeted expenditures decelerated in 2008 compared to the pace of growth in 2006 (20%) and 2007 (13%).

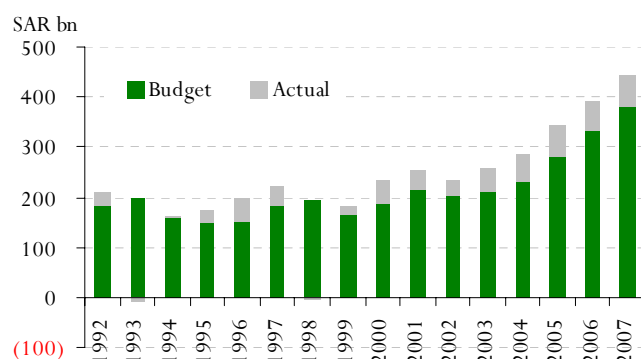
Chart 6: Evolution of Budgeted Expenditures



Sources: MOF and NCB

Budgetary overruns have been the norm historically, so the impact is stable on a year on year basis. We believe actual expenditures will most likely exceed budgeted expenditures by an average of 15-20%, as has been historically the case. However, given that actual expenditures were already 17% higher than budgeted in 2007, budgetary overruns are likely to remain a constant feature in the current business cycle.

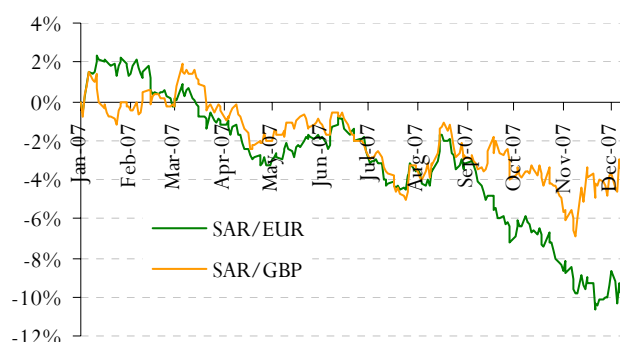
Chart 7: Budgetary Overruns



Sources: SAMA and NCB

In addition, domestic inflationary pressures and NEER depreciation imply that the real growth in the budget is slightly lower than headline figures. Given that approximately 40% of the budget will be allocated to capital expenditures (including construction activities and imports), we believe that the surge in construction material prices and the nominal effective depreciation of the SAR could imply that the growth in real budgeted expenditures is slightly lower than the headline figure of 8%. In 2007YTD, the SAR depreciated 9.8% and 3.8% vis-à-vis the EUR and GBP, respectively, mirroring the USD weakness against both currencies. So far, our estimates suggest that commodity prices will remain high in 2008 and the USD may very possibly continue its weakness versus anchor currencies.

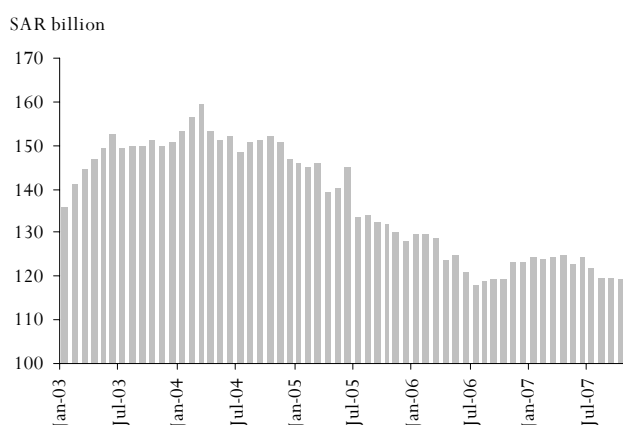
Chart 8: SAR vis-à-vis the EUR and GBP (1 Jan07=0%)



Source: NCB

The government, however, is obviously adopting indirect expansionary policies through its prudent management of fiscal surpluses. Out of the 2007 fiscal surplus, the government has allocated SAR53.5 billion to settle domestic public debt, and SAR25 billion to build housing capacity through the Saudi Real Estate Development Fund. This policy is instrumental to promote private sector growth, alleviate poverty, and meet human development needs over the longer-run. The prepayment of domestic debt is also another form by which petrodollars can be injected into the economy, aside from direct government expenditures. Finally, the MOF announced that the Specialized Credit Development Institutions will disburse SAR16.2 billion loans in 2008, another evidence of the growing bias towards indirect fiscal stimulus.

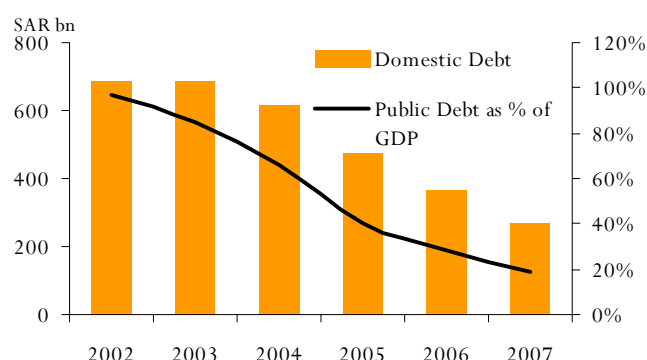
Chart 9: Banking System Claims on the Government



Sources: SAMA and NCB

While the government continues to reduce domestic public debt, not certain if future resources will be available, it contributes to the growth of liquidity in the banking system. As Chart 9 depicts, domestic public debt has fallen both in absolute terms and as a percentage of GDP over the years. The continued decline in banking system claims on the government, as shown in Chart 10, is also a reflection of Saudi Arabia's initiatives to provide more funding resources to the private sector.

Chart 10: Domestic Debt as a Percentage of GDP



Sources: SAMA and NCB

III. Concluding Remarks

First, the 2008 budget is prudently expansionary in nominal and real terms but even more so if the impact of debt settlement and Saudi Real Estate Development fund capital increase are taken into account. If the recently announced mega projects (USD389 billion) are implemented as scheduled, these funds will be instrumental in financing capital and working capital requirements going forward.

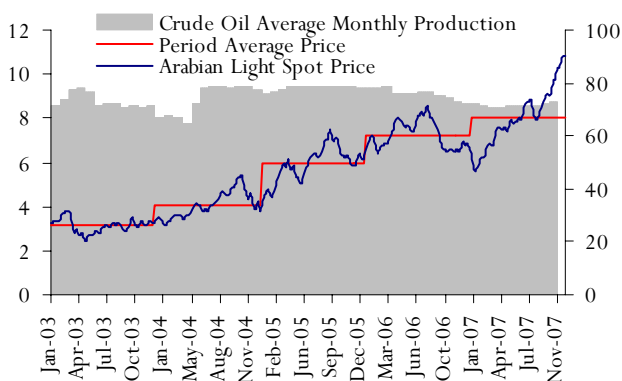
Second, from an economic growth perspective, the growing bias towards indirect fiscal stimulus packages falls perfectly in line with ongoing market liberalization. So far, private non-oil investment has lagged government investment in fueling domestic demand. The 2007 and 2008 budget are gearing up to prepare for the inevitable reversal of this trend, as government investment in infrastructure and utilities sets the stage for an upcoming private sector-led investment boom.

Finally, from a fiscal perspective, we also believe that the prudently expansionary 2008 budget is appropriate at this stage of the business cycle and at this juncture in the Saudi structural development process. In 3Q2007, oil prices have come under upward pressure, mainly due to tight supply/demand fundamentals, which have been exacerbated by a weakening USD. Given that the government was plagued by persistent deficits and debt burden throughout the 1980s and 1990s, we believe that fiscal prudence is a highly commendable policy stance.

Annex 1: Macroeconomic Update

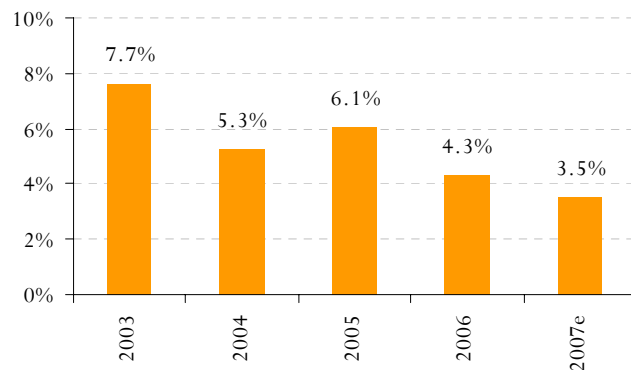
1. Despite the 5.5% decline in average crude oil production levels in 2007YTD, average Saudi Light crude prices were 11% higher than average 2006 prices.

Chart 1: Crude Oil Prices and Production



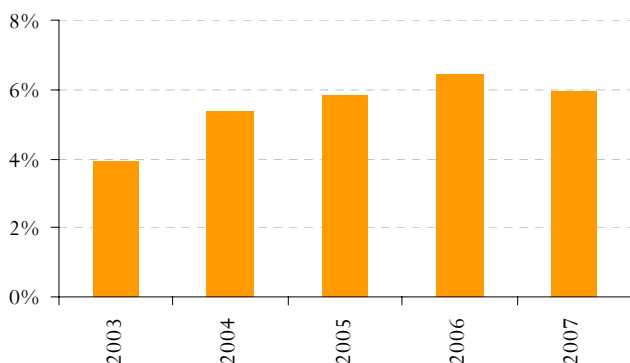
2. The decline in crude oil production levels put a damper on real GDP growth rate. According to the MOF, real GDP growth decelerated to 3.5% in 2007, down from 4.3% in 2006.

Chart 2: Real GDP Growth Rate



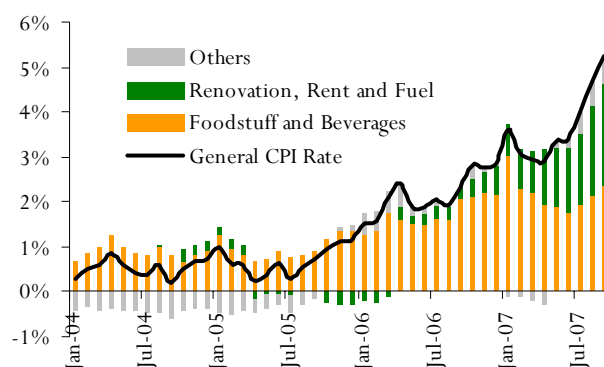
3. Growth in private sector GDP, however, remained strong on the back of broad-based hype in the non-oil industrial, construction, and transport sectors.

Chart 3: Annual Growth in Private Sector Real GDP



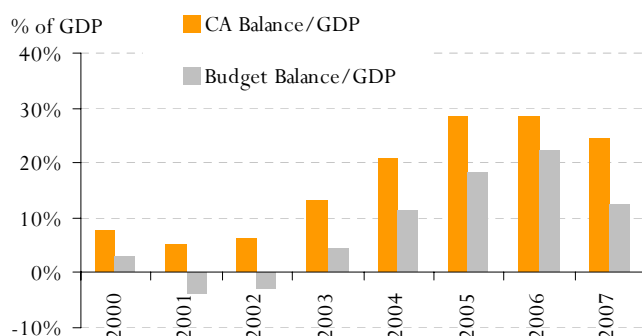
4. Robust domestic demand, NEER depreciation and a series of supply shocks pushed the annual inflation rate to unprecedented levels.

Chart 4: Y-o-Y Inflation Rate (Cost of Living Index)



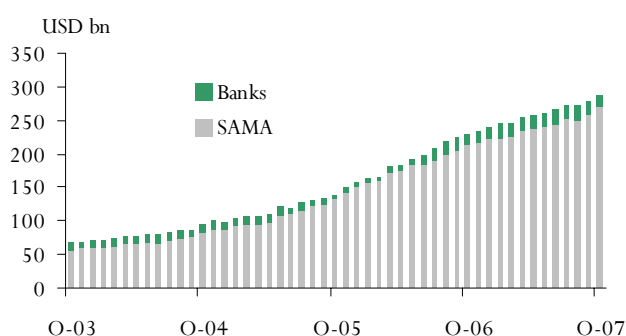
5. Record high crude oil prices and fiscal prudence fuelled hefty twin balances. The current account and fiscal surpluses to GDP ratio stood at 24.4% and 12.6% in 2007, respectively.

Chart 5: Twin Surpluses-to-GDP Ratio



6. Accordingly, net foreign assets in the banking system overshot to USD288 billion by October 2007, providing strong cushion against terms of trade shocks.

Chart 6: Net Foreign Assets in the Banking System



Sources: SAMA, EIA and NCB

Annex 2: 2008 Budget and Announced Budgetary Allocations by Sector/ Institution

The 2008 budget estimates total revenues at SAR450 billion, total expenditures at SAR410 billion and a surplus of SAR40 billion. Out of the SAR410 billion budgeted expenditures, total capital investment represents approximately 40%, inclusive of both green-field projects and capacity expansions. Below, we summarize the key budgetary allocations as presented in the Ministry of Finance press release.

Sector/ Institution	Allocation
Education and Manpower	Aggregate expenditures are projected at SAR105 billion (25.6%), out of which SAR39 billion are embarked for capital expenditure projects. According to the MOF, new projects to be implemented in 2008 include 2,074 schools added to the 4,352 schools currently under construction, rehabilitation of 2,000 existing schools, appropriations for the University of Northern Boarder Region, the infrastructure of the new Girls' University campus in Riyadh, and the opening of 41 new colleges, 7 new technical colleges for girls and 16 vocational training centres.
Health and Social Affairs	Aggregate expenditures are projected at SAR44.4 billion (10.8%), out of which SAR6.3 billion are embarked for capital expenditure projects. New projects include 250 primary health care centres, 8 hospitals, and a number of social centres and welfare offices.
Municipality Services	Aggregate expenditures are projected at SAR17 billion (4.1%), out of which SAR14 billion are embarked to capital expenditure projects. New projects include inter-city roads, intersection and bridges, road lights, and cleaning related projects.
Transportation and Telecommunications	Aggregate expenditures are projected at SAR16.4 billion (4%), out of which SAR14.6 billion are embarked to capital expenditure projects. New projects include plans for additional 7,300 kilometres of roads, to be added to 24,000 km of roads currently under construction, ports, airports, railroad developments and new postal services.
Water, Agriculture and Infrastructure	Aggregate expenditures are projected at SAR28.5 billion (6.9%), out of which SAR20.9 billion to capital expenditures. New projects include water, sewage, and desalination projects worth SAR13.3 billion. The budget also includes SAR7.6 billion allocated to the two industrial cities of Jubail and Yanbu, and other industrial and agricultural projects.
Specialized Credit Institutions	The government plans to inject SAR25 billion to the Real Estate Development Fund over five years.

The Economics Department Research Team

Head of Research

Dr. Said A. Al Shaikh
Editor/Chief Economist
s.alshaikh@alahli.com

Sector Analysis/Saudi Arabia

Muhammad Y. Malick
Senior Economist
y.malick@alahli.com

Mazen A. Tammar
Senior Economist
m.tammar@alahli.com

Macroeconomic Analysis

Perihan Al-Husseini
Economist
p.alhusseini@alahli.com

Management Information System

Walaa S. Shaheen
MIS Officer
wa.shaheen@alahli.com

Majed Al Ghalib
MIS Specialist
m.alghalib@alahli.com

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To be added to the NCB Economics Department Distribution List

Please contact: Mr. Noel Rotap
Tel.: +966-2-646-3232
Fax: +966-2-644-9783
Email: n.rotap@alahli.com