December 2013
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Saudi Arabia's 2014 Budget Report

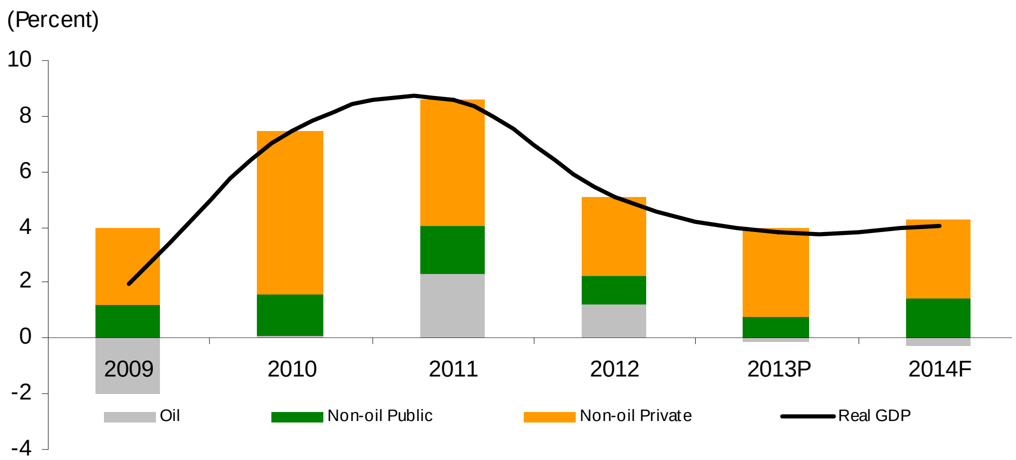
More of the Same

Contents

Highlights and NCB Views

On Monday, 23 December 2013, the Council of Ministers endorsed the government's budget for 2014 and announced the final outcome of fiscal operations and macroeconomic performance for 2013. The highlights are:

- The fiscal balance remained in surplus for the fourth year in a row, albeit edging lower to SAR206 billion in 2013, approximately 7.4% of GDP, driven by increased expenditure and lower oil revenues.
- The Saudi economy grew at a slower pace, the lowest since 1.8% in 2009, with real GDP registering 3.8% annual growth, as the oil sector contracted by 0.6% Y/Y. However, the contraction in the oil sector was offset by non-oil sector that grew by around 5%.
- Importantly, the non-oil private sector increased by 5.5% Y/Y, driven by construction, trade, and manufacturing that grew by 8.1%, 6.2% and 4.7%, respectively.
- The 2014 budget estimates revenues at SAR855 billion and expenditures at SAR855 billion, projecting a break-even. The budget continued to emphasize both human and physical capital expenditure to support sustainable and balanced growth.
- We project total revenues at SAR973 billion and expenditures at SAR953 billion, predicting a surplus of SAR20 billion in 2014. Our forecast is based on an average Arabian light oil price of USD100/bbl for 2014.
- The oversupply theme might seem plausible next year, with Libya reopening three oil exports and Iran shipping more oil after the nuclear deal with the West. Yet, the inherent instability in Libya's oil and the lag that will take for Iran to pump close to 4MMBD might derail such scenario till 2H 2014. Thus, OPEC might be able to preempt by cutting its production below 30 MMBD in the scheduled June meeting. Hence, Arabian light prices will remain range-bound, protected at a floor of USD80/bbl in 2014, resulting in lower current account and fiscal surpluses and a marginal increase in net foreign assets.



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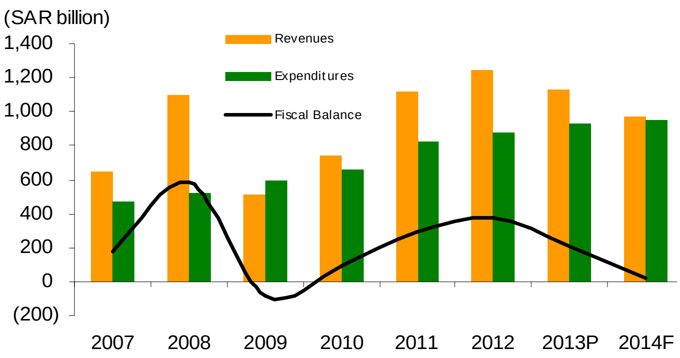
Macroeconomic Indicators	2010	2011	2012	2013P	2014F	Latest	Date
Real Sector							
Average Arab Light Spot (USD/bbl)	78	108	110	105.0	100.0	106.4	11M13
Average Saudi Crude Oil Production (mbd)	8.2	9.3	9.8	9.6	9.4	9.6	11M13
GDP at Current Market Prices (SAR billion)	1976	2511	2666	2794.8	2835.0	-	-
GDP at Current Market Prices (USD billion)	527	670	712	746.3	757.0	-	-
Real GDP Grow th Rate, %	7.4%	8.6%	5.8%	3.8%	4.1%	-	-
CPI Inflation (Y/Y % Change, Average)	3.8%	3.7%	2.9%	3.6%	3.3%	3.1%	Nov-13
External Sector							
Trade Balance (USD billion)	154	245	247	214	186	-	-
Current Account Balance (USD billion)	67	159	165	130	105	-	-
Current Account/GDP	13%	24%	23%	17.4%	13.9%	-	-
Net Foreign Assets w ith SAMA (USD billion)	441	536	648	713	749	710	Oct-13
Fiscal Sector							
Actual Revenues (SAR billion)	742	1,118	1,247	1131	973	-	-
Actual Expenditure (SAR billion)	654	827	873	925	953	-	-
Overall Budget Balance (SAR billion)	88	291	374	206	20	-	-
Budget Balance/GDP	4%	12%	14%	7.4%	0.7%	-	-
Break-Even Oil Price (USD/bbl)	64.1	75.3	73.9	81.1	86.8	-	-
Financial Sector							
SAR/USD Exchange Rate	3.75	3.75	3.75	3.75	3.75	3.75	Oct-13
Grow th in Broad Money (M3)	5.0%	13.3%	13.9%	10.9%	10.0%	10.4%	Oct-13
Grow th in Credit to the Private Sector	4.8%	11.0%	16.4%	13.5%	15.3%	13.1%	Oct-13
Average 3M SAR Deposit Rate	0.7%	0.7%	0.9%	1.0%	1.2%	1.0%	10M13

Source: Reuters, SAMA and NCB

I. Macroeconomic and Fiscal Performance in 2013

The budget balance remained in surplus supported by robust oil revenues. Yet, in percentage terms, it fell to 7.4% of GDP, the first single-digit figure since 4.4% in 2010. Despite the marginal decline in oil production and oil prices, revenues remained above SAR1 trillion for the third year in a row, registering SAR1,131 billion in 2013. Lower oil revenues coupled by increased expenditures that hit a new record above the SAR900 billion threshold have pushed the fiscal balance lower into a surplus of SAR206 billion compared to a surplus of SAR374.1 billion in 2012.

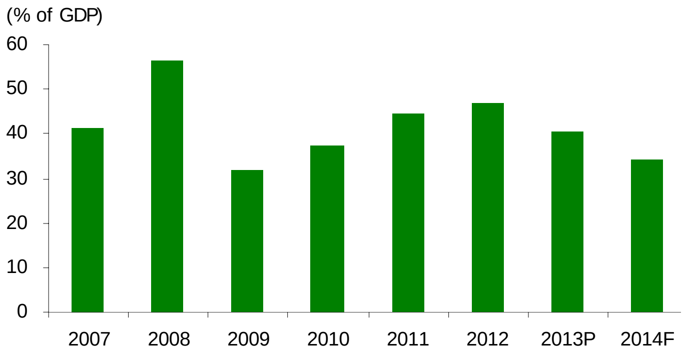
Figure (1): Fiscal Balance



Sources: MOF, SAMA and NCB

Fiscal revenues fell on the back of marginally lower oil prices and production in 2013. The Arabian light average spot prices has reached USD106.4/bbl in 2013YTD, a 3.4% decrease compared to 2012 average prices. In addition, the drop in oil production has reduced revenues, with Saudi oil production averaging 9.56 MMBD in 2013YTD, around 0.2 MMBD lower than last year's 9.76 MMBD. Consequently, the published pre-closing figures for the current fiscal year ending Dec 2012, showed total revenues of SAR1,131 billion, of which SAR1,017.9 billion represented direct oil revenues, a 36.4% increase over 2013 budgeted revenues.

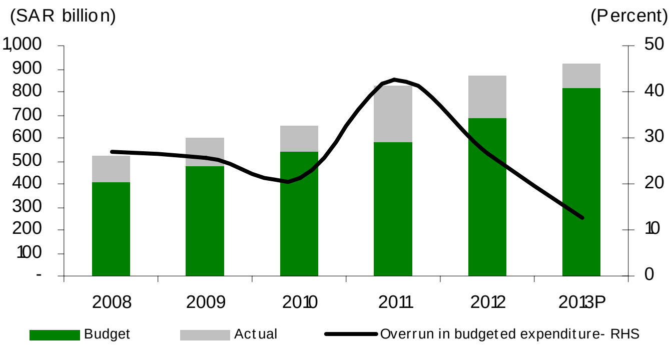
Figure (2): Fiscal Revenues in % of GDP



Sources: MOF, SAMA and NCB

Actual expenditures registered a historical high. 2013's expenditures are estimated to have reached SAR925.0 billion, representing 12.8% increase above budget and about 5.9% higher than actual expenditures in 2012. Capital expenditures remained elevated, posting SAR157 billion in new projects in addition to outlays for on-going projects that according to our estimates will bring the total amount spent on CAPEX closer to SAR277.5 billion, the third year that the outlays crossed the SAR200 billion mark. Meanwhile, additional capital expenditure amounting to SAR18.0 billion have been financed from excess surpluses of previous budgets. As expected, the royal decrees continue to underpin the rise in current expenditures. The permanent measures that included an increase in minimum wage in the public sector, employing more than 60 thousand Saudis, and an increase in social security contributed to current expenditures that are estimated at SAR647.5 billion, a record high. The recent drive by the Ministry of Labor to expel illegal workers and strictly apply the Saudization program have started to pay off with 723 thousand Saudis being employed by the private sector since the start of the program. The positive outcome from these dynamics budget-wise will be felt in the medium-term, as the rise in social security payments, unemployment benefits and government employment gets contained.

Figure (3): Budgetary Overruns

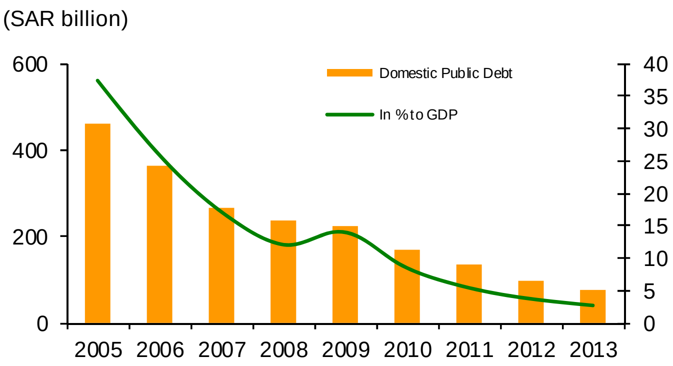


Sources: MOF, SAMA and NCB

Saudi Arabia's external position attained another surplus. The current account increased to reach around USD130 billion (or 17.4% of GDP), compared to USD164.8 billion last year, registering 21.2% decrease due to lower oil export earnings. Imports also increased by 8% to a record USD153.3 billion. Over 10M2013, net foreign assets with SAMA have increased to USD709.6 billion from USD648.5 billion at the end of 2012, leaving official foreign reserves at a very healthy position covering more than 55.0 months of imports, near a historical record. SAMA's net foreign assets are expected to marginally grow based on the elevated oil revenues in 2013. As such, they will continue to provide an important buffer to protect the economy from gyrations in oil prices in case of an oversupply theme or negative repercussions from tapering.

The Kingdom's domestic debt fell to SAR75.1 billion, 2.7% relative to GDP. We believe that the government has enough reserves to pay off the entire debt, yet it opts 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 lower debt level on a global scale was cited by S&P and Fitch as a reason for affirming the Kingdom's rating at AA$^-$ with a positive outlook in May and September. Despite the decline in overall debt, SAMA opted out from the respite mode this year, issuing T-bills worth SAR34 billion, the largest since 2010, to mop excess liquidity. This increased activity from the regulator coincided with credit growth in 1Q that was near 4-year highs.

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



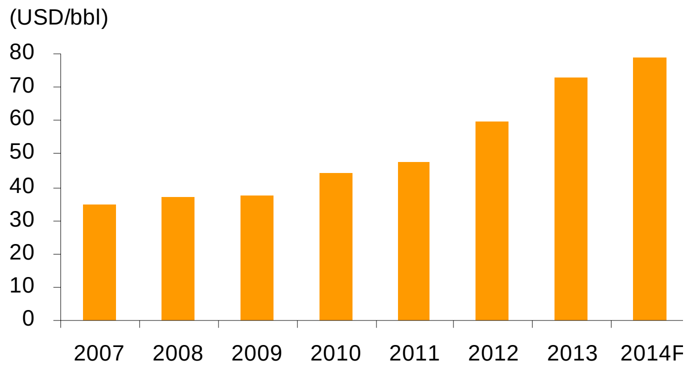
Sources: MOF and SAMA

II. Fiscal Budget Outlook in 2014: More of the Same

The government is adamant in pursuing expansionary policy to diversify the economy and ensure sustainable growth. The 2014'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 24.6% of total allocations, with health accounting for 12.6% of the budget. The 2014 budget release estimates revenues and expenditures at SAR855 billion and SAR855 billion, respectively, projecting a break-even. However, we believe that revenues are underestimated, and the government will still manage to record a relatively smaller surplus in 2014. Meanwhile, strong external positions coupled with huge foreign reserves will underpin capital expenditure. On the execution side, the value of government-related awarded construction contracts year-to-date exceeded last year's robust momentum, reaching SAR157 billion compared to SAR120.4 billion awarded during the same time period in 2012.

Oil prices will remain supportive. 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 USD79/bbl. With our forecast of USD100/bbl for the average Arabian light spot prices and a 9.4 MMBD for average oil production in 2014, we project revenues and expenditures at SAR973 billion and SAR953 billion, respectively. This would lead to a mere budget surplus of SAR20 billion, or 0.7% of estimated GDP in 2014.

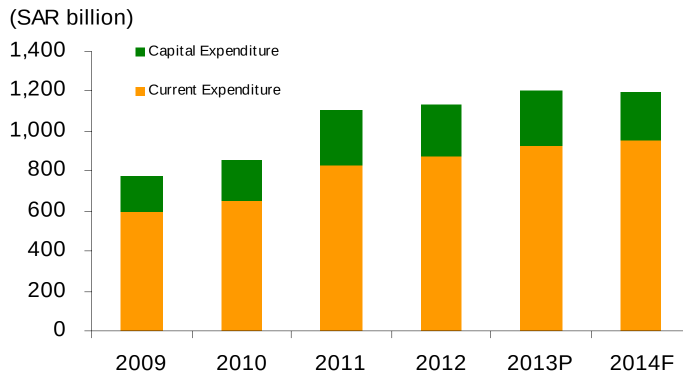
Figure (5): Implicit Budget Oil Price



Sources: NCB

Current expenditures higher than budgeted due to wage bills. The budget still focuses on capital expenditures; however, as reiterated earlier we believe current expenditures will continue its rise due to permanent fiscal measures that were undertaken in 2011. Out of SAR855 billion, around SAR607 billion or 71% is allocated to current expenditures, largely to pay for wages and salaries. The remaining SAR248 billion is allocated to capital expenditures, representing around 13% decrease compared to 2013. The budget prioritizes spending on physical and social infrastructure development, namely education and health (see Annex 2). However, based on historical evidence actual capital expenditures will end up well below budgeted figures. Therefore, we project capital expenditures at SAR238.2 billion in 2014, while current expenditures at SAR714.6 billion.

Figure (6): Actual Expenditure



Sources: MOF, SAMA and NCB

The government continues to allocate funds to specialized credit institutions to support balanced development. Based on the announcement, around SAR85.3 billion in 2014 will be disbursed by specialized credit institutions to finance industrial projects and to support social development, thus, complementing private credit growth that recorded 13.1%Y/Y in October 2013. A case in point is the SAMAPCO project for ethylene dichloride and caustic soda, whereby Public Investment Fund (PIF) is extending a loan worth SAR0.7 billion. The Saudi Industrial Development Fund (SIDF) has also recently approved 19 loans valued at SAR2.8 billion for 15 new industrial projects and the expansion of 4 projects. During the first three quarters of this year, the Saudi Credit and Saving Bank has financed 1,495 SMEs, granting more than SAR376 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 SAR1.59 billion by the end of 2Q 2013 to 574 establishments, representing 16.5% of the aggregate beneficiaries since the inception of the program in January 2006.

Oil prices are projected to average USD100/bbl during 2014. After peaking in 1Q 2013, oil prices nosedived in second quarter as the taper talk intensified, but prices recovered since the third quarter as economic data from the US and China became increasingly positive. Political uncertainty, geopolitical tensions, and fundamentals have created a tight market balance underpinning the Arabian light benchmark that averaged USD106.4/bbl year-to-date, slightly lower than last year's USD110.2/bbl. The outlook for 2014 will relatively be less certain than last year's. If supply shortages from Libya and Nigeria were positive for oil prices in 2013, supply will act negatively in the months ahead, with Libya reopening three oil export ports and as Iran ships more oil after the nuclear deal with the West. Yet, supply from Libya can be characterized as unstable and uncertain. In addition, it will take a couple of months for Iran to regain its previous pre-sanctions. Thus, OPEC might be able to preempt any oversupply fears by cutting its production below 30 MMBD in the scheduled June meeting. Effectively, OPEC output did fall below the quota in the last two months, reaching 29.64 MMBD in November, which reflects increased compliance. Additionally, the Fed tapering and the dollar-positive nature of its implementation might be negative on oil. However, positive data stream from the US and China can counter the tapering effects. In our opinion, Saudi Arabia's production is expected to drop to 9.4 MMBD and coupled with Kuwait, Qatar, and UAE's ability to reduce production, prices should be maintained around the USD100/bbl.

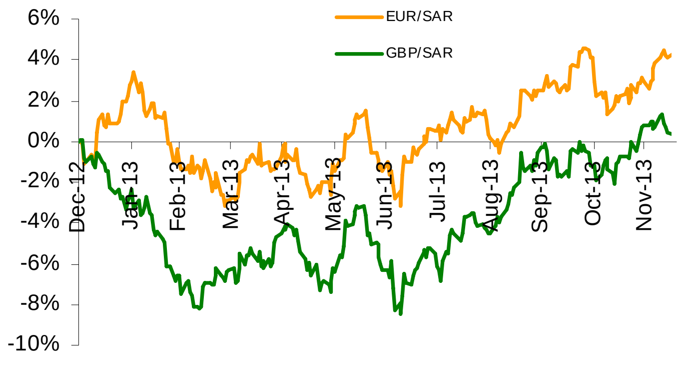
In 2014, elevated oil prices will result in fiscal surplus. Based on our forecast of oil prices at USD100/bbl, we project a fiscal surplus of SAR20 billion or 0.7% of GDP. This will result in oil revenues of SAR848 billion, representing a decrease of 16.7% compared to actual oil revenues in 2013, which also takes into account a 3.9% decline in export volume. Non-oil revenues are expected to reach SAR125 billion, 10.4% above actual level of 2013. Actual expenditures will likely exceed budgeted expenditures by 11.4% to reach SAR953 billion.

(SAR billion)	2013 Actual	2014 Budget	2014 Forecast
Total Revenue	**1,131**	**855**	**973**
Oil	1,018	752	848
Non-Oil	113	103	125
Total Expenditure	**925**	**855**	**953**
Current	648	607	715
Capital	278	248	238
Deficit/Surplus	**206**	**0**	**20**

Sources: CDSI and NCB

Inflation will likely hover around 3% in 2014, underpinned by weaker imported inflation and lower commodity prices. In 2013, prices edged higher, averaging 3.6% till date, due to higher food prices. The liquid state of the economy was supportive of higher consumption expenditure, which drove up local food prices that averaged 5.9% Y/Y, higher than 4.5% Y/Y registered in 2012. The steep decline in global food prices witnessed since October, with the Reuters/Jefferies CRB Index losing more than 4.5% in a couple of weeks, is expected to soften domestic prices in the first half of 2014. On the rental component, prices maintained a slightly higher pace than 2012, albeit low compared to the 2007-2011 period by averaging 3.4% in 2013YTD. Accelerating the implementation of the mortgage law will positively impact the local real estate market by providing financing to home seekers. With unemployment at an all-time low, 11.7% by the end of 3Q2013, an expected increase in disposable income will boost private consumption expenditure, which posted an 8.5% increase last quarter. However, the dollar-positive tapering and the lower commodity prices will underpin the headline inflation rate, which, in our opinion, will remain in a range-bound movement around 3% next year.

Figure (7): SAR vis-à-vis EUR and GBP



Sources: Reuters and NCB

Ⅲ. Concluding Remarks

Unlike 2013, the year 2014 will prove to be a challenging time for policy making. The broader international economic environment will be relatively volatile next year with the long overdue tapering exercise being implemented by the Federal Reserve. Asset classes across the board including commodities will be negatively impacted, especially that a stronger dollar will reduce the appeal of commodities as alternative investments. The interest rate environment will adjust upwards, resulting in a tighter and more costly external borrowing.

Lower crude oil prices and reduced production might materialize, with the increased possibility of oversupply from OPEC and non-OPEC, which will weigh negatively on oil revenues and will reverse the hefty fiscal and current account surpluses of recent years. Nevertheless, the substantial net foreign assets will act as a buffer, allowing the government to maintain an expansionary fiscal policy stance to weather any adverse external shocks.

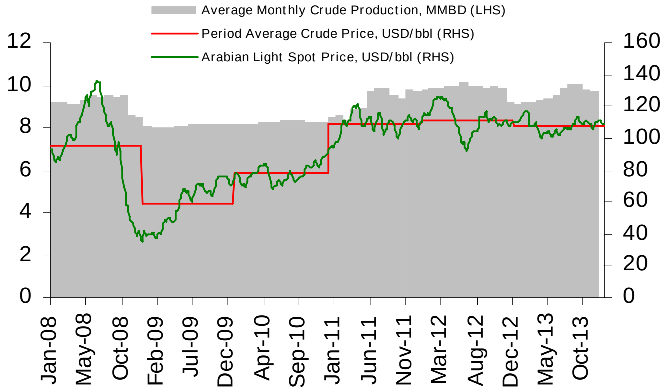
However, there are a number of key points in the 2014 budget that lead us to believe that Saudi Arabia will be able to sustain economic growth ahead. First, the elevated capital expenditure will continue to boost non-oil growth in the near to medium-term. It also sends a positive signal to the private sector, which will improve overall confidence levels in the economy. Moderating global commodity prices and the expected effective nominal appreciation of the SAR, especially that tapering is dollar positive, imply that growth in the budget can be larger in real terms. Finally, we still do believe that restraining growth in current expenditure could imply higher government savings, and as more resources are injected through specialized credit institutions, this will enhance and support private sector activities.

Going forward, We project real GDP growth of 4.1% for 2014. 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 sector, which is estimated to grow by 5.4%, driven by the private sector, mainly construction, trade and manufacturing .

Annex I: Macroeconomic Update

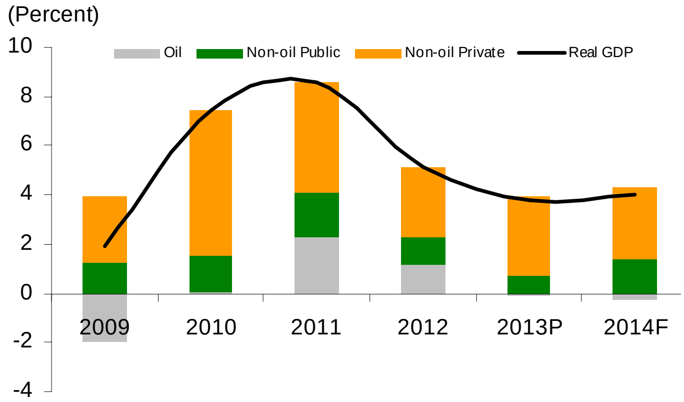
1. Crude oil prices inched lower from an average of USD110/bbl in 2012 to USD106/bbl in 2013YTD and Saudi crude oil production marginally fell from 9.76 million b/d in 2012 to 9.56 million b/d in 2013YTD.

Figure (1): Crude Oil Prices and Production



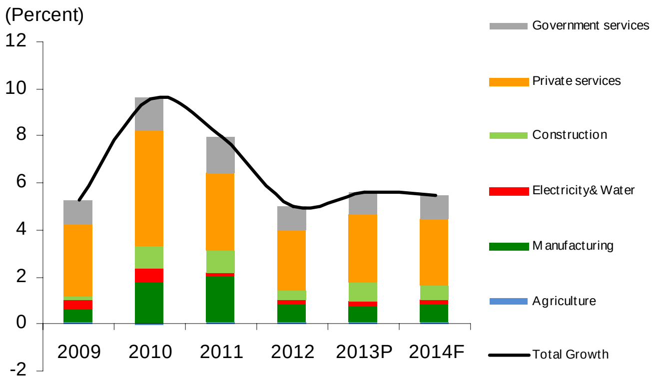
2. Accordingly, real GDP slowed down from 5.8% in 2012 to a projected 3.8% in 2013.

Figure (2): Real GDP Growth, Contribution



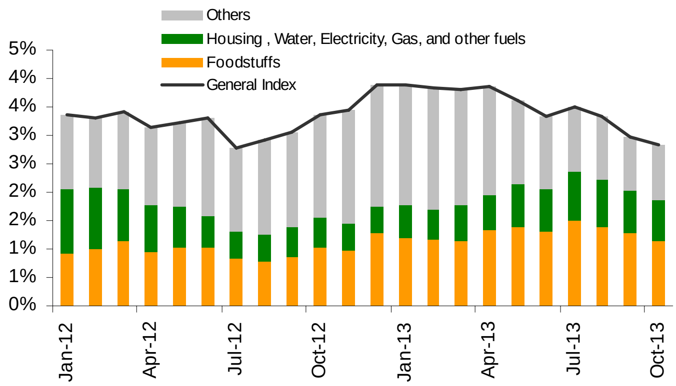
3. Non-oil private GDP continued to register robust growth 5.5% in 2013, particularly in construction, trade and manufacturing.

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



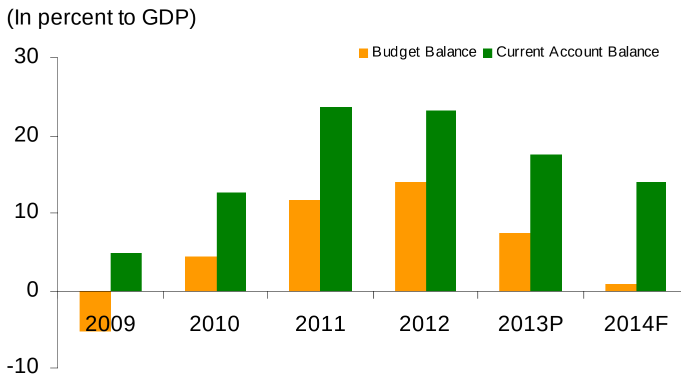
4. Inflation increased from 2.9% in 2012 to an average of 3.6% in 2013YTD, on the back of domestic food prices that rose from an average of 4.5% last year to 5.9% YTD.

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



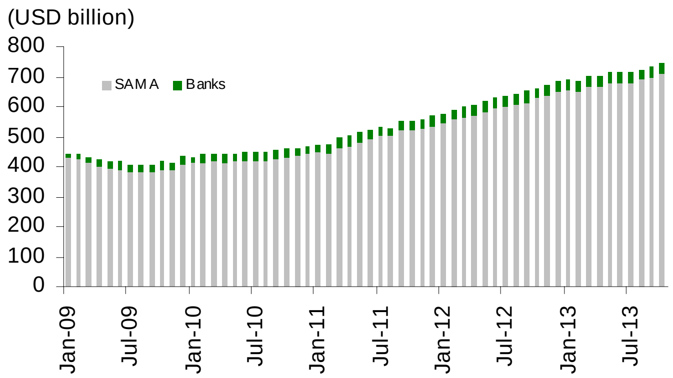
5. The external and fiscal balances remained in surplus, registering 17.4% and 7.4% of GDP in 2013. Yet, they have fallen in comparison to last year.

Figure (5): Twin Surpluses



6. As such, net foreign assets have grown to USD709.6 billion in 2013YTD from USD648.5 billion in 2012.

Figure (6): Net Foreign Assets



Sources: MOF, SAMA, Reuters and NCB

Annex 2: 2014 Budget and Announced Budgetary Allocations by Sector/Institution

The 2014 budget estimates total revenues at SAR855 billion and total expenditures at SAR855 billion, a budgeted break-even. Out of the SAR855 billion budgeted expenditures, total capital expenditures represent approximately 29%, 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 expenditure 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 SAR210 billion (25% of total), about 3% higher than the amount budgeted for last year. New projects include 465 schools, in addition to 1,500 schools that will be renovated and work will continue on the 1,544 schools currently under construction. 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 SAR108 billion (12.6% of total), about 8% over the amount budgeted in 2013. New projects include primary healthcare centers, 11 new hospitals, and completing the construction work of 132 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 SAR39 billion (4.6% of total), an increase of 9% over the budget in 2013. 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 SAR66.6 billion (7.8% of total), which is 2.5% higher than the amount budgeted for last year. New projects include 3,500 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 the industrial cities of Jubail, Yanbu and Ras Al-Khair.
Water, Agriculture and Manufacturing	Expenditures are projected at SAR61 billion (7.1% of total), up by 5.7% over the amount in the 2013 budget. The budget includes appropriations to enhance water resources, as well as to improve water and sewage networks.

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