2007 Budget

Fiscal Policy Remains Prudently Expansionary

24 December 2006

Highlights and NCB Views

- On 18 December 2006, the Saudi Ministry of Finance (MOF) announced the final outcome of fiscal operations in 2006, overviews of macroeconomic performance in 2006 and the budget of 2007. The actual fiscal surplus in 2006 stood at SAR265 billion, 20% of GDP and only 3.5% higher than our projected SAR257 billion. Crude oil production cuts, on the other hand, put a damper on real GDP growth rate, which decelerated to 4.2% in 2006, down from 6.6% in 2005.

- Budgeted expenditures in 2007 came in 13.4% higher than budgeted expenditures in 2006 whereas budgeted revenues stood at SAR400 billion, nearly flat in nominal terms compared to 2006 budgeted revenues. However, in real terms, after adjusting for the rising costs of construction materials and nominal effective exchange rate (NEER) depreciation, growth in budgeted expenditures is likely to be slightly lower than the headline figure.

- Nonetheless, the indirect expansionary impacts of the 2007 budget are deemed to be far more important than the direct impact. The MOF recently announced it will negotiate a call back of outstanding treasury securities and also decided to allocate SAR20 billion to increase the capital of the Public Investment Fund (PIF). In effective terms, these two actions amount to liquidity injection operations.

- In fact, the greater focus of the budget on capital expenditure, debt retirement and reserve accumulation whilst simultaneously replenishing the main funding sources of the private sector (mainly banks and the PIF) is highly commendable at this stage of the cycle. Non-oil private sector investment has so far lagged government investment and our projections suggest that this trend will likely reverse aggressively over the medium-term.

Macroeconomic Indicators

	2003	2004	2005	2006e	2006f	Latest	Date
Real Sector							
Average Saudi Light Crude (USD/B)	26.0	33.9	49.6	-	61.0	60.5	11M06
Average Crude Oil Production Level (MMBD)	8.4	8.9	9.4	-	9.4	9.2	11M06
Nominal GDP in Current Market Prices (SAR bn)	804.6	938.7	1,157.4	1,301.0	1343.0	-	-
Nominal GDP in Current Market Prices (USD bn)	214.6	250.3	308.6	346.9	358.1	-	-
Population (mn)	22.0	22.5	23.1	-	23.7	-	-
GDP/Capita (USD)	9,745	11,111	13,351	-	15,111	-	-
Real GDP Growth Rate	*7.7%*	*5.3%*	*6.6%*	*4.2%*	*6.0%*	-	-
Inflation Rate, End of Period	0.3%	0.5%	1.6%	-		2.5%	Sep-06
External Sector							
Merchandise Trade Balance (USD bn)	59.1	84.6	125.5	147.5	164.2	-	-
Current Account Balance (USD bn)	28.0	51.9	90.0	95.4	123.9	-	-
Current Account Balance/GDP	*13.1%*	*20.7%*	*29.2%*	*27.5%*	*34.6%*	-	-
Net Foreign Assets in the Banking System (USD bn)	70.4	99.0	157.3	-		228.3	Oct-06
Fiscal Sector (Central Government)							
Actual Revenues (SAR bn)	293.0	393.0	555.0	655.0	625.0	-	-
Budgeted Expenditures (SAR bn)	209.0	230.0	280.0	335.0	335.0	-	-
Actual Expenditures (SAR bn)	257.0	295.0	337.0	390.0	368.0	-	-
Expenditure Overrun (In Percentage)	*23.0%*	*28.3%*	*20.4%*	*16.4%*	*9.9%*	-	-
Actual Fiscal Balance (SAR bn)	36.0	98.0	218.0	265.0	257.0	-	-
Fiscal Balance/GDP	*4.5%*	*10.4%*	*18.8%*	*20.4%*	*19.1%*	-	-
Monetary Sector							
USD/SAR Exchange Rate	3.75	3.75	3.75	3.75	3.75	Peg	-
YoY Growth in M3	*6.9%*	*18.8%*	*11.6%*	-	*13.0%*	*14.7%*	Oct-06
YoY Growth in Credit to the Private Sector	*11.0%*	*37.4%*	*38.9%*	-	*10.0%*	*13.8%*	Oct-06
Average 3M Deposit Rate on SAR-denominated Deposits	*1.6%*	*1.7%*	*3.7%*	-	-	*5.0%*	10M06
Average 3M Deposit Rate on USD-denominated Deposits	*1.1%*	*1.5%*	*3.5%*	-	-	*5.1%*	10M06
Interest Rate Differential, in Basis Points	50.0	20.0	22.0	-	-	-7.0	10M06

F = NCB forecast

Prepared By

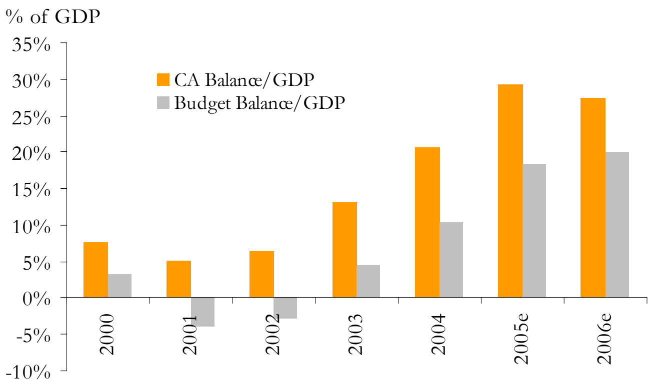
Dr. Said Al Shaikh
Chief Economist
S.alshaikh@alahli.com

Hany Y. Genena
Senior Economist
h.genena@alahli.com

I. Macroeconomic Performance in 2006

In line with expectations, Saudi Arabia fiscal surplus to GDP ratio jumped to a record 20.5% in 2006. According to the announcement, fiscal revenues and expenditures accelerated 40% and 14% to SAR655 billion and SAR390 billion, respectively. The current account surplus, which is partially a reflection of public savings, stood at SAR358 billion (USD95 billion) in 2006, approximately 27.5% of estimated GDP. Chart 1 below depicts the evolution of the twin balances of Saudi Arabia from 2000 until 2006.

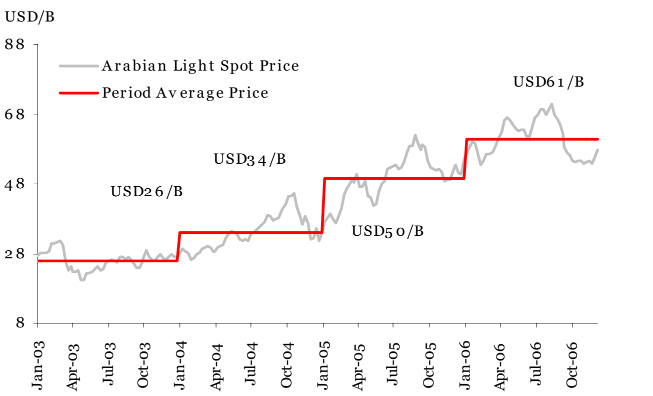
Chart 1: Twin Balances of KSA



Sources: SAMA and NCB

High average crude oil prices in 2006 were instrumental in fuelling the twin surpluses. Despite the recent correction in crude oil prices and the recent cuts in production levels, average Saudi Light spot crude oil price in 2006YTD was 22% higher than average 2005 prices. Accordingly, fiscal revenues soared to an all-time-high of SAR655 billion, or approximately 50% of estimated GDP.

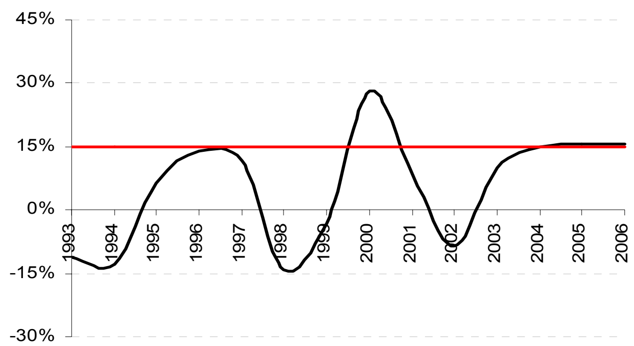
Chart 2: Saudi Light Crude Spot Price



Sources: EIA and NCB

Growth in actual expenditures, interestingly, remained nearly stable at around 14% for the third year in a row. In 2006, actual expenditures stood at SAR390 billion, compared to budgeted expenditures of SAR335 billion and actual 2005 expenditures of SAR341 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.

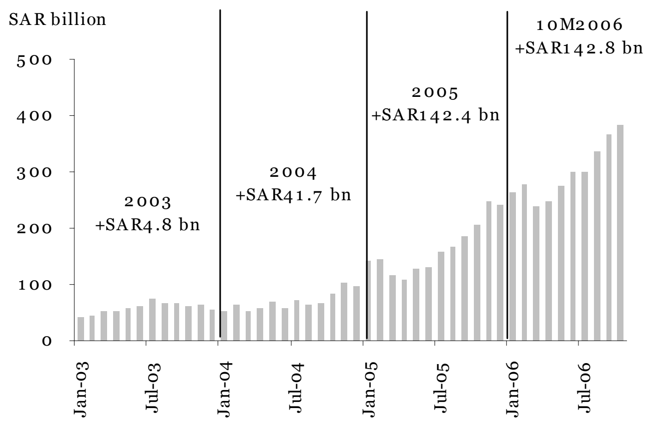
Chart 3: Annual Growth in Actual Expenditures



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 2003 until October 2006, these deposits surged from SAR43 billion to SAR383 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 and Fitch to upgrade the sovereign credit rating of Saudi Arabia to A+ in 2006.

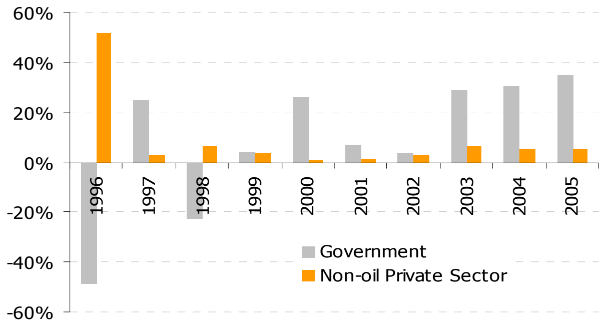
Chart 4: Government Deposits in SAMA



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 2005. Later in the report, we will see that this asymmetric growth in investment demand perfectly explains the hidden dynamics of the 2007 budget.

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

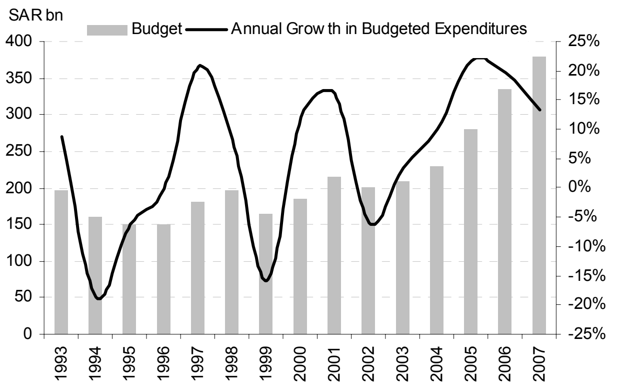


Sources: SAMA and NCB

II. 2007 Budget: Indirect Fiscal Stimulus Gaining High Weight

Budgeted expenditures in 2007 came in 13% higher than the 2006 budget. In nominal terms, the government earmarked SAR380 billion for 2007 expenditures, out of which SAR140 billion (37%) are allocated for capital expenditures. As depicted in Chart 6 below, growth in nominal budgeted expenditures decelerated in 2007 compared to the pace of growth in 2005 (22%) and 2006 (20%).

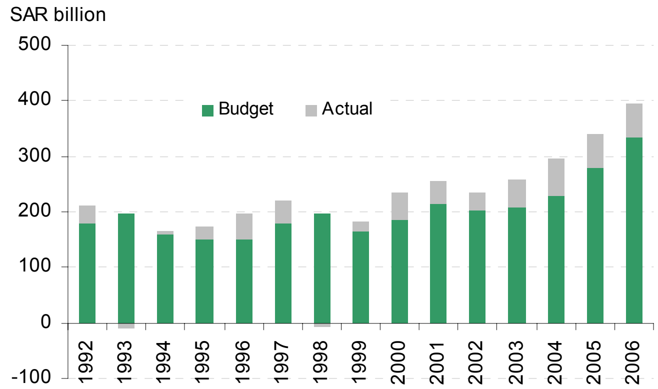
Chart 6: Evolution of Budgeted Expenditures



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 16% higher than budgeted in 2006, the impact of budgetary overruns will still be constant on a year on year basis.

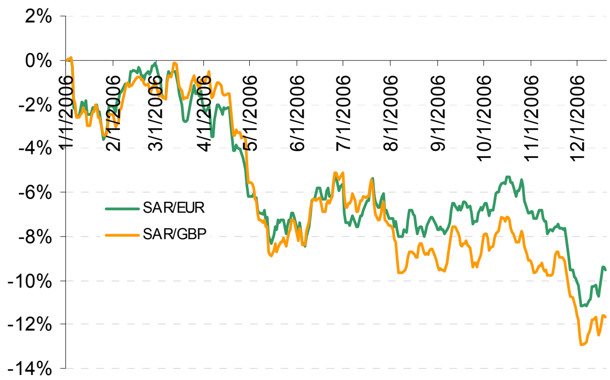
Chart 7: Budgetary Overruns



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 one-third 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 13%. In 2006, the SAR depreciated 9.5% and 12% 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 2007 and the USD may very possibly resume its weakness versus anchor currencies.

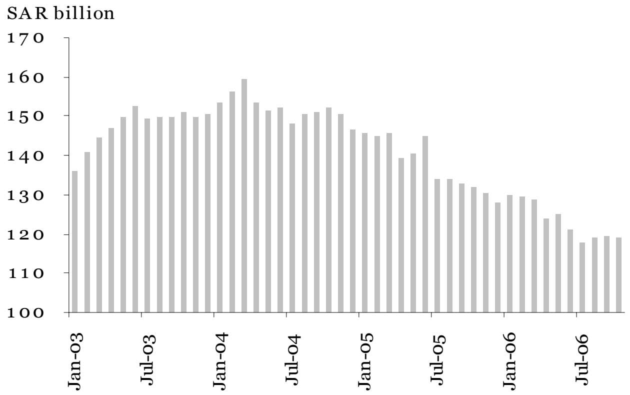
Chart 8: SAR vis-à-vis the EUR and GBP (1 Jan 06 = 0%)



Source: NCB

The government, however, is obviously adopting indirect fiscal expansion policies via its plan to call back outstanding treasury securities and inject SAR20 billion in the PIF. What made us inclined to believe that the government is adopting this policy approach is the latest decision of the MOF to negotiate a full call back of outstanding treasury securities prior to maturity. In effective terms, this prepayment of domestic debt is just another form by which petrodollars are injected into the economy aside from direct government expenditures. In addition, the MOF announced it will inject SAR20 billion of capital into the Public Investment Fund (PIF), another evidence of the growing bias towards indirect fiscal stimulus.

Chart 9: Banking System Claims on the Government



Sources: SAMA and NCB

Inevitably, recent policy shifts support the crowding in hypothesis. In 2006, upon accession to the WTO in December 2005, the government resumed its corporatization program by converting the Saudi Railroad Authority to the Saudi Railroad Company and approving the establishment of the National Water Company, as highlighted in the budget announcement. In addition, the government announced the upcoming privatization of the national flag carrier (SAUDIA). This is in addition to surging capital inflows into the petrochemicals sector, banking sector and insurance sectors.

III. Concluding Remarks

First, the 2007 budget is prudently expansionary in nominal and real terms but even more so if the impact of debt settlement and PIF capital increase are taken into account. If the recently announced mega projects are implemented as scheduled, these funds will be instrumental in financing capital and working capital requirements going forward.

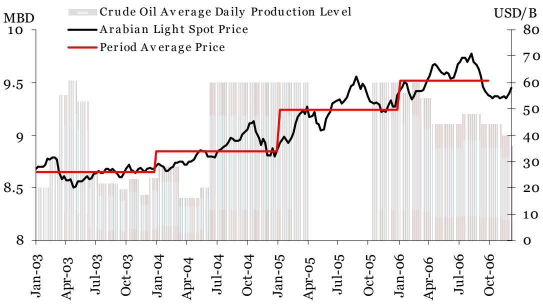
Second, from an economic growth perspective, the growing bias towards indirect fiscal stimulus packages falls perfectly in line with ongoing market liberalization. So far, private non-oil investment has significantly lagged government investment in fueling domestic demand. The 2007 budget is gearing 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 2007 budget is appropriate at this stage of the business cycle and at this juncture in the Saudi structural development process. In 4Q2006, oil prices have come under downward pressures due to a slowing US economy and build up of inventories whereas production cuts have been already instituted and implemented by most OPEC members. 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

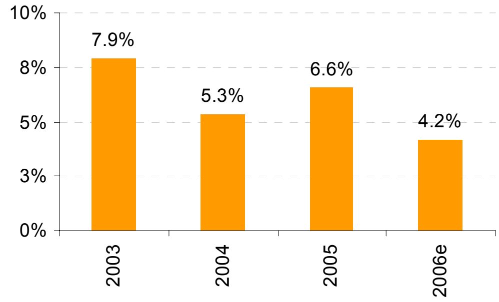
1. Despite the 3% decline in average crude oil production levels in 2006YTD, average Saudi light crude prices were 23% higher than average 2005 prices .

Chart 1: Crude Oil Prices and Production



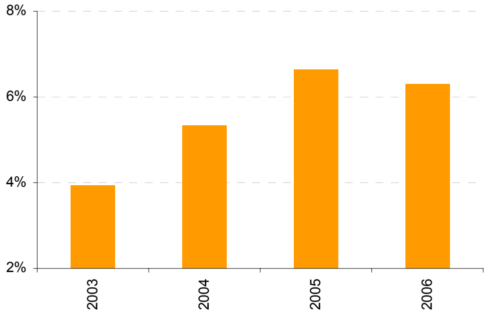
2. The decline in crude oil production levels put a damper on real GDP growth rate. According to the MOF, real GDP growth decelerated to 4.2% in 2006, down from 6.6% in 2005.

Chart 2: Real GDP Growth Rate



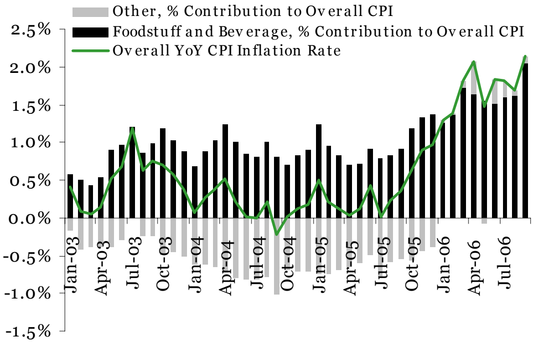
3. Growth in private sector GDP, however, remained strong on the back of broad-based hype in the non-oil industrial, construction, and transport sectors.

Chart 3: Annual Growth in Private Sector Real GDP



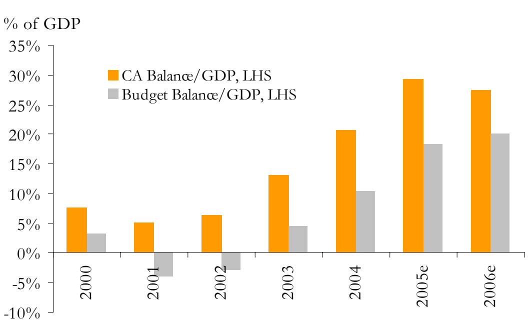
4. Robust domestic demand, NEER depreciation and a series of supply shocks (bird flu and ban on Australian meat) pushed the annual inflation rate above the 2% mark for the first time in years.

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



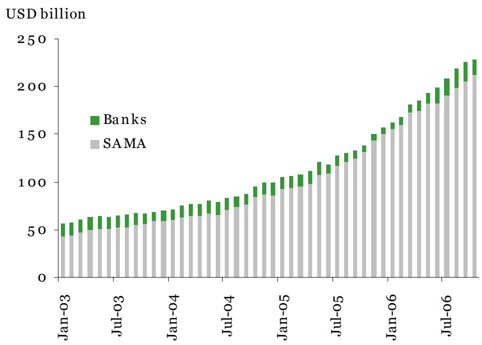
5. Record high crude oil prices and fiscal prudence fuelled hefty twin balances. The current account and fiscal surpluses to GDP ratio stood at 27.5% and 20.0% in 2006, respectively.

Chart 5: Twin Surpluses-to-GDP Ratio



6. Accordingly, net foreign assets in the banking system over-shot to USD228 billion by October 2006, providing strong cushion against terms of trade shocks.

Chart 6: Net Foreign Assets in the Banking System



Sources: SAMA, EIA and NCB

Annex 2: 2007 Budget and Announced Budgetary Allocations by Sector/Institution

The 2007 budget estimates total revenues at SAR400 billion, total expenditures at SAR380 billion and a surplus of SAR20 billion. Out of the SAR380 billion budgeted expenditures, total capital investment represents approximately one third (36.8%) 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 SAR96.7 billion, out of which SAR29 billion are earmarked for capital expenditure projects. According to the MOF, new projects to be implemented in 2007 include 2,000 schools added to the 4,800 schools currently under construction, four new universities in Tabuk, Albaha, Najran and Girls University in Riyadh, 56 colleges, 7 new technical colleges, and 12 technical and vocational training centres.
Health and Social Affairs	Aggregate expenditures are projected at SAR39.5 billion, out of which SAR5.6 billion are earmarked for capital expenditure projects. New projects include 380 primary care centres, 13 hospitals and a number of social centres and welfare offices.
Municipality Services	Aggregate expenditures are projected at SAR15.5 billion, out of which SAR11.1 billion are earmarked to capital expenditures. New projects include inter-city roads, bridges, road lights and cleaning-related projects.
Transportation and Telecommunications	Aggregate expenditures are projected at SAR13.6 billion, out of which SAR9.3 billion is earmarked to capital expenditures. New projects include plans for additional 8,000 kilometres of roads, ports, airports, railroad developments and new postal services.
Water, Agriculture and Infrastructure	Aggregate expenditures are projected at SAR24.8 billion, out of which SAR16.4 billion are earmarked to capital expenditures. New projects include water, sewage, and desalination projects. The budget also includes allocations to the two industrial cities of Jubail and Yanbu, agricultural projects and flour mill projects.
Specialized Credit Institutions	The government plans to inject SAR20 billion in the form of capital contribution to the Public Investment Fund (PIF).