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Economic Research Note

Saudi 2015 Budget: More than meets the eye

- **Public finances less conservative than 2015 budget suggests; fiscal breakeven oil price to fall to $78/bbl**
- **Realized expenditure likely to be cut by 8.4% this year; still it will stay much higher than budgeted levels**
- **Fiscal breakeven price to double by 2022 in the absence of fiscal reform and an OPEC/non-OPEC agreement**

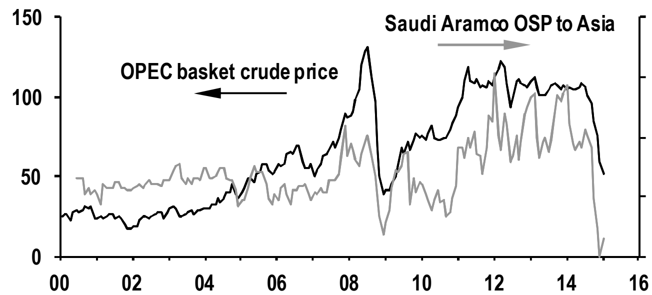
With oil prices falling more than 50% in less than six months, financial markets have increasingly focused on the implicit Saudi view on oil markets. Extrapolating this view became even more relevant after the Saudi crown prince said OPEC would not cut production, even at $20/bbl. In fact, since the summer Saudi Arabia has cut its Official Selling Price differential to Asia to levels not seen even at the height of the Great Recession, suggesting that the Kingdom is looking for other oil producers to share the adjustment burden so it preserves its market share. The Saudi 2015 budget therefore has taken on particular importance to the Kingdom's economic outlook and to the global economy as a signal of official oil policy intentions.

The budget appears conservative, projecting a 16% fall in public revenues and a modest 0.5% increase in spending. Assuming that Saudi crude production remains nearly unchanged at 9.6mb/d this year, budgeted revenues imply a Saudi crude price of $55/bbl, while the fiscal breakeven price required to balance the budget is $67/bbl. At first glance these figures suggest the Kingdom is prepared to live with much lower oil revenues. Yet, we think 2014 budget performance highlights a more nuanced view. In 2014, the government spent 28.6% more than projected in the budget law. The budgeted expenditures for 2015 would thus entail a 22% cut in public spending, should budget execution remain close to initial projections. Over the previous 45 years, such sharp public spending cuts occurred only in 1986, 1988, and in the aftermath of the First Gulf War. In other words, we expect spending to exceed the budget and Saudi fiscal policy to remain supportive and dependent on much higher oil prices.

Budget execution confirms need for higher oil prices

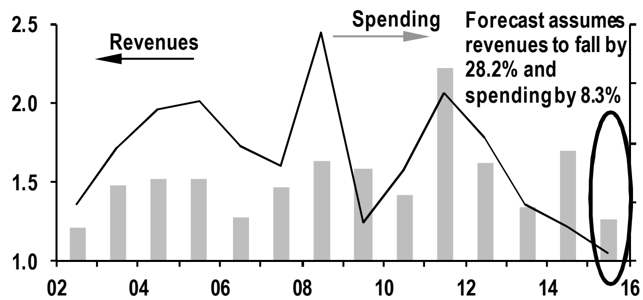
The biggest surprise in the 2015 budget announcement was 2014 realized spending, which reached SAR1,100bn compared to our forecast of SAR1,078bn and budgeted spending of SAR855bn. As a multiple of budgeted spending, realized spending reached the second highest level in 12

Oil prices and Saudi Official Selling Price Differential
$/bbl, both scales



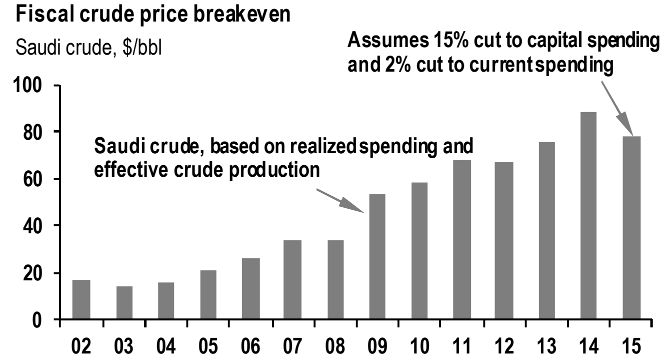
Source: Bloomberg and J.P. Morgan

Execution vs planned budget
Multiples of budgeted levels



Source: Saudi Ministry of Finance and J.P. Morgan

Fiscal crude price breakeven
Saudi crude, $/bbl



Source: SAMA, Saudi Ministry of Finance, and J.P. Morgan

years. The Kingdom has thus maintained the level of overspending despite the sharp fall in oil prices in 2H14. The fiscal breakeven oil price based on budget execution and effective crude production, i.e., the level that we think most closely mirrors the government's view on oil markets, rose to a historical high of $88/bbl in 2014 (Saudi crude) compared to $15/bbl in 2000.

We believe lower oil prices will drive the government to cut capital spending on non-priority projects this year; we assume that capital spending will be reduced by 15% and current spending by 2% in 2015. Still, we project total expenditures will be just above the SAR1tn mark and 17% higher than the SAR860bn assumed in the budget. We have thus revised our 2015 fiscal deficit forecast to 10.1% of GDP from 6.6%, assuming an average Saudi crude price of $60/bbl and average crude output at 9.6mb/d. If the Kingdom raises total spending by 5% instead of our base-case 8.4% cut, the budget deficit would widen to 15.9% of GDP. All else equal, every $10/bbl fall in the average oil price widens the fiscal deficit by 4.1%-pts of GDP. The 2015 budget deficit will mainly be financed by domestic resources, in our view, with public debt likely to reverse its downtrend from 1.9% of GDP in 2014. We believe the government is unlikely to draw on its external savings (97% of GDP) unless oil price weakness lasts a few years.

The commitment to ongoing infrastructure projects partly explains the 2014 overspending. Outlays for projects that will be completed this year also are high and should maintain upward pressure on overall public spending (second chart). Several ongoing projects—such as the expansion of airports (US$11.9bn) and the railways, which accounts for almost half of total infrastructure commitments—will be difficult to delay or phase out. Importantly, the expansion of the two Holy Mosques (for which the cost has not been disclosed) remains a top priority and likely will remain on schedule. Several real estate projects such as the house-building program are financed from a special account at the Saudi Arabian Monetary Agency (SAMA). Capital spending suffered large cuts during the 1980s and commitments to projects will be much lower after 2015 (first and second charts).

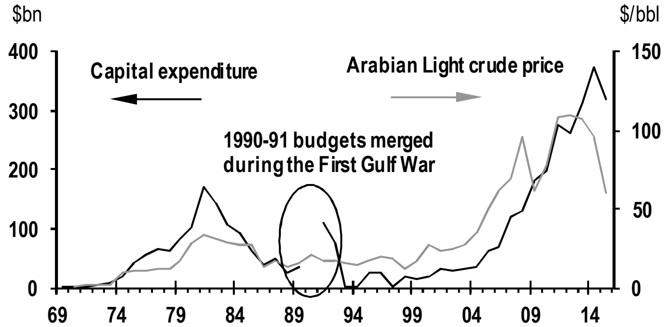
Public finances much more dependent on oil prices despite large buffers

The sixfold increase in the fiscal breakeven oil price since 2000 has substantially reduced the flexibility of public finances. In addition, the young and fast-growing population has heightened the urgency of reducing oil dependence and the pressure on the public sector as an employer of first resort of the indigenous population. Thus, the commitment to medium-term projects near 100% of GDP is unlikely to be derailed by weaker oil prices over the next two years. The growing population and diversification needs also boost domestic energy demand and, thus, the opportunity cost of energy subsidies. We estimate the cumulative opportunity cost since 2004 at US$450bn. Reforming energy should become a key theme in coming years should oil prices remain weak. Yet, we believe future fiscal reform will be gradual.

Assuming that public spending grows 5% a year after being cut 8.4% in 2015, the government's external savings would be depleted by early-2022 if they were used to finance all budget shortfalls. This assumes that Saudi oil production and prices remain unchanged at 9.6mb/d and US$60/bbl. If the government increased spending by 5% in 2015 as well, SAMA's US$734bn external reserves (ex.-gold) would be depleted by early 2020. If oil prices average US$40/bbl, external savings would be depleted by 2018. Realistically, we expect the government will favor an increase in domestic debt rather than using all external savings. Yet, these calculations highlight that the Kingdom has enough buffer to pressure other oil producers to share the adjustment burden. This view is reinforced by the fact that the Kingdom has one of the lowest oil price cash costs among oil producers.

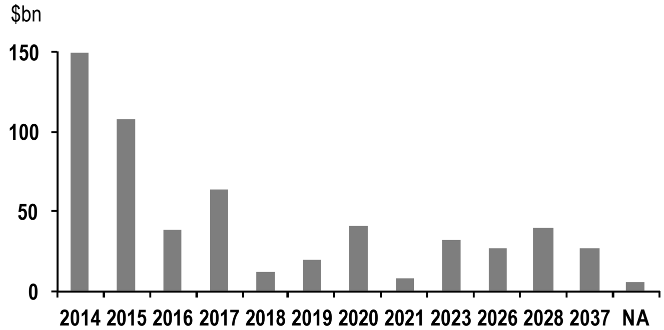
In the absence of fiscal reforms, the sensitivity analysis in the table points to the need to maintain high levels of production so the fiscal breakeven price remains in double-digits. Still, the oil price breakeven will increase above US$100/bbl by 2020 even if crude production stays near historical highs at 10mb/d. If the Kingdom unilaterally cuts production to 8mb/d to rebalance oil markets, all else equal, the fiscal breakeven price would increase to US$153/bbl by 2022. The table partly explains why the Kingdom has stopped acting as the swing producer since last summer. In our view, Saudi Arabia is unlikely to re-embrace its role of swing producer until OPEC and non-OPEC countries agree to cut supply.

Public capital expenditure and oil prices



Source: SAMA, Saudi Ministry of Finance, and J.P. Morgan

Top 100 Saudi projects by completion date



Source: ZAWYA and J.P. Morgan

Sensitivity analysis: Saudi oil price for budget breakeven $/bbl

Oil output mb/d	2015	2016	2017	2018	2019	2020	2021	2022
7	119	127	135	144	154	164	175	188
8	99	105	112	119	127	135	144	153
9	85	90	96	102	108	115	122	130
10	74	79	84	89	94	100	106	113

Source: J.P. Morgan estimates

Assumes spending to be cut by 8.4% in 2015 and to be increased by 5% thereafter; domestic consumption to increase by 3.2% on average; all else being equal