جدوى للإستثمار
Jadwa Investment

March 2016

Monetary and Financial Update

Pace of Slowdown in Monetary Aggregates to Moderate in 2016

- **Monetary Policy - Global:** The US Federal Reserve's (Fed) policy normalization path faces headwinds as global equity market turmoil and low oil prices persist.

- **Monetary Policy - Domestic:** SAMA will be cautious in responding to changes in US interest rates, particularly given negative sentiment associated with lower oil prices, which itself is adding to the cost of borrowing.

- **Money Supply:** The pace of the slowdown in money growth will likely moderate in 2016 following its rapid slowdown towards the end of 2015.

- **Claims on the Public Sector:** We anticipate net sovereign bond issuances to banks and other autonomous government institutions to reach SR120 billion in 2016, compared to SR98 billion in 2015.

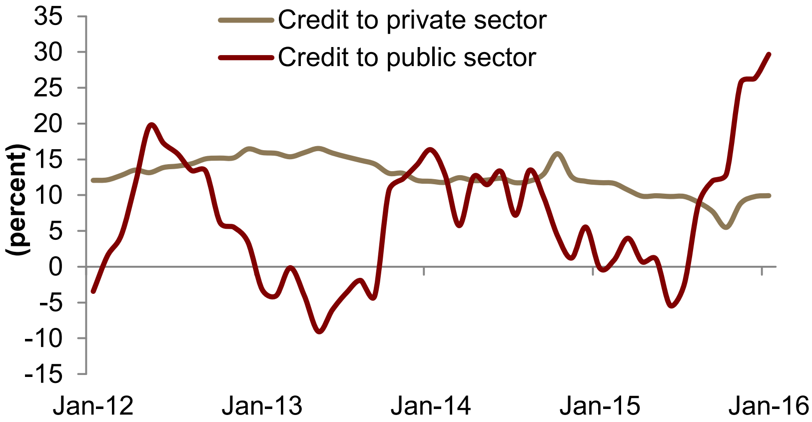
- **Credit to Private Sector:** We forecast further slowdown in credit growth, putting the full year expansion in credit at 6 percent in 2016.

- **Sectoral Credit**: Within the private economy in 2015, net new credit was higher, year-on-year towards commerce, construction, services, and utilities.

- **Financial Soundness:** The financial system is sufficiently liquid and can provide room to counter any contraction in money supply during 2016.

- **Capital Outflows:** We expect the recent surge in capital outflows to subside when investors are reassured of the government's commitment toward structural economic reform.

Figure 1: Bank claims by institutional sector
(year-on-year change)



Key Indicators
Percent, year-on-year

Indicator	Jan 2015	Jan 2016
M3	7.7	3.7
Credit to private sector	11.7	9.9
Credit to public sector	-0.2	29.7
Total deposits	7.7	3.4
Loan-to-deposit ratio	81.6	86.1

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Global monetary outlook

We see recently released economic data forcing the Fed to embark on a gradual interest rate tightening cycle during 2016.

The US Federal Reserve's (Fed) decision to raise interest rates in December 2015 has been down to anticipated rises in inflationary pressure as slack in the labor market is slowly diminishing. We see recently released economic data, which showed the US economy grew by a meagre 0.7 percent in the final quarter of 2015, and the deflationary effect of a devaluation in the Chinese currency, forcing the Fed to embark on a gradual interest rate tightening cycle during 2016. Nevertheless, risks linked to further, albeit gradual, tightening still remain. Firstly, any further increases in the interest rate will result in the Dollar gaining more value. The trade-weighted dollar has been increasing in value over the last year and further gains could push it to 13-year highs, all of which could adversely impact export competitiveness. Secondly, rises in the rate of interest would increase borrowing costs for corporates, especially those engaged in borrowing heavily from the high-yield debt market. Particularly vulnerable is the US high-yield energy sector where outstanding debt has grown from $80 billion in 2009 to around $260 billion in 2015, the majority of which is held within the shale oil industry.

US Inflation edged upwards to 1.4 percent in January, its highest in 16 months.

Nevertheless, inflation, a key factor driving the Fed's decisions, has edged upwards to 1.4 percent in January, its highest in 16 months, as the impact of falling energy prices fades away. Further, the core index –which excludes the effect of energy and food prices– rose in January to 2.2 percent year-on-year, its highest since June 2012. However, risks that inflation would stay below the Fed's 2 percent target include the persistence of a strong US Dollar, which has so far kept a downward pressure on prices in the form of cheaper imports. Also, any further devaluation to the Chinese renminbi could put more downward pressure on inflation and increase the risk of falling prices globally and in the US.

The normalization path currently being pursued by the US Fed is already resulting in capital flight from emerging markets to the US.

The normalization path currently being pursued by the US Fed is already resulting in capital flight from emerging markets to the US, which is also strengthening the Dollar vis-à-vis other currencies. Under these circumstances, many emerging markets are running the risk of also having to raise interest rates in order to maintain a strong currency (Figure 3), and limit the impact of potential currency crises. Countries with high US Dollar denominated debt such as Turkey and South Africa stand out. A global environment of higher interest rates could stifle growth, especially in countries that have previously benefited from low borrowing costs to fuel government deficits.

Figure 2: Trade weighted US Dollar

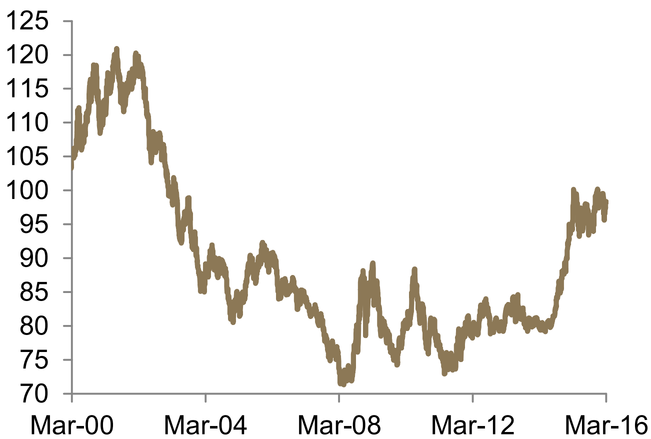
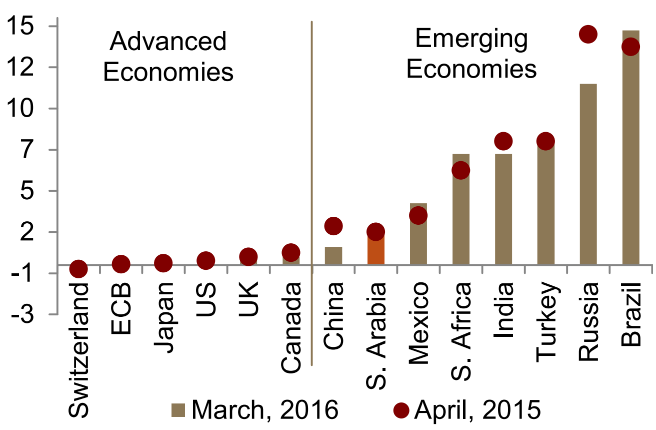


Figure 3: Central bank policy rates
(as of March 3, 2016)



Higher US interest rates are also having a damaging effect on global financial markets.

Higher US interest rates are also having a damaging effect on global financial markets, which have been triggered by panic over a tumble in the Chinese equity market as fears of an economic slowdown in China intensified. Nonetheless with limited inflationary pressure featuring in the US economy, the normalization path is therefore expected to be gradual, even as unemployment reaches pre-crisis levels. Such an interest rate rise would not be significant enough to discourage business activity. We also see that the current environment of low oil prices is providing counter inflationary pressure in emerging markets as well, allowing many countries more freedom to pursue a looser monetary policy. Europe and Japan - both of which are fighting deflationary pressures - are already benefitting from higher US interest rates, and lower currency values, which would assist in facilitating export growth.

Saudi monetary and financial outlook

We believe that SAMA will be cautious in responding to such changes in US interest rates…

...particularly given the negative sentiment surrounding lower oil prices…

...which itself is adding to the cost of borrowing.

Normalization of monetary policy in the US should theoretically translate into lower growth in bank credit to the private sector within the Kingdom. This should eventually reduce the potential growth of the non-oil sector. The likely transmission would be through higher repo rates in the Kingdom. This is a particular cause for concern given the negative sentiment surrounding lower oil prices, which itself is adding to the cost of borrowing, given the recent rise in the 3-month Saudi Interbank Offer Rate (SAIBOR) (Figure 4). We think higher rates will benefit banks through higher profitability, since a large proportion of their liabilities are denominated in non-interest bearing demand deposits. That said, previous incidences show that interest rate pass-through effects have been minimal on demand for credit, and that government spending is the main catalyst behind such growth in demand for credit. Nevertheless, we believe that SAMA will be cautious in responding to such changes in US interest rates. We therefore do not expect the spread between Saudi and US policy rates to be lower than what it has been since 2008.

Signs are already pointing to a gradual slowdown in government spending…

Signs are already pointing to a gradual slowdown in government spending, which has contributed to slowing growth in monetary aggregates. The high spending earlier in 2015, coupled with a 51 percent year-on-year decline in oil revenues, has put downward pressure on foreign reserves. This led the government to start a new series of sovereign bond issuance in June 2015, the first such issuance since 2007. As a result, monetary aggregates have showed a slowing trend in recent months, confirming our earlier view that the

Figure 4: 3-month SAIBOR

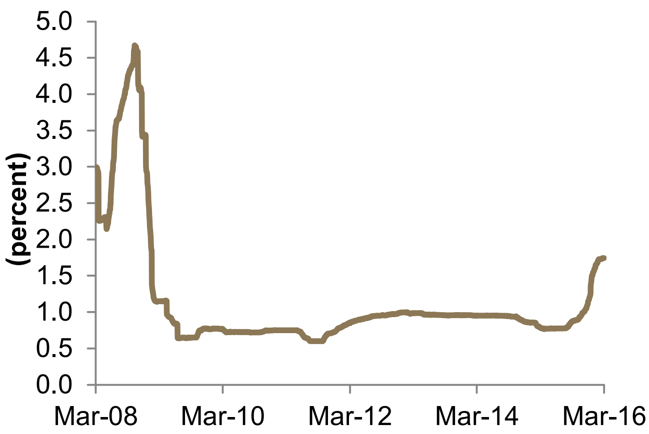
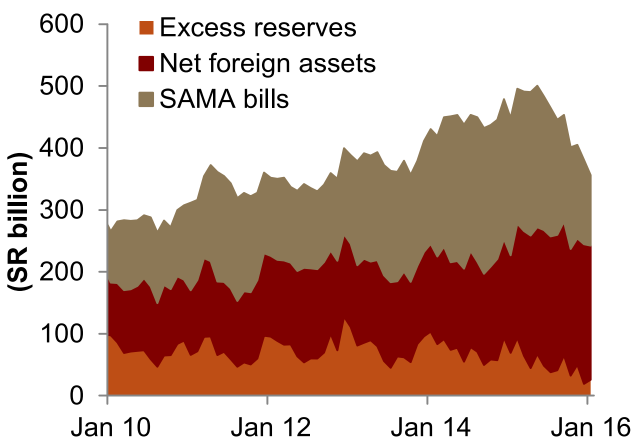


Figure 5: Excess liquidity in the banking system



...with monetary aggregates showing a slowing trend in recent months.

prospect of running deficits and any consequent reduction in public spending will lead to a slowdown in most monetary indicators. Nevertheless, data on monetary aggregates, as well as bank loans and deposits up to January 2016, continued to show positive growth, remaining consistent with a growing non-oil sector.

Since 2008 until mid-December 2015, SAMA's key policy reverse repo rate was left unchanged at 0.25 percent, whilst the repo rate remained 175 basis points above the US Federal Funds Rate. During the same period, the Saudi economy maintained an expansionary stance, even as liquidity levels fell, deposits slowed, and interest rates rose. We think that the rise in SAIBOR reflects, in part, lower oil prices, as well as the uncertainty of government payment schedules to contractors and suppliers of goods and services.

Claims on the public sector to continue rising

We expect the government to continue with its series of bond issuance to domestic banks and other public institutions.

Despite the prospect of fiscal deficits in coming years, we view the Kingdom's credit profile as fundamentally solid…

...and should provide enough room for a gradual fiscal consolidation.

We expect the government to continue with its monthly SR20 billion ($5.3 billion) series of development bond issuance to domestic banks and other public institutions, with net bond issuance reaching SR120 billion (14 percent of budgeted spending) during 2016. This will follow similar issuances in 2015, which at the time led to a SR98 billion rise in net bond issues. The breakdown of total monthly issuances by type of bondholder is not disclosed, which makes it difficult to have an exact estimate of the value issued on a gross basis. Also, news sources reported that the government issued a new series of floating rate bonds in January 2016, with rates ranging from –30 to +5 basis points over the three-month SAIBOR, depending on the maturity of the tranche. This series of sovereign bond issuance will be crucial in maintaining development spending on the economy whilst preserving foreign reserves, but a risk stemming from the deficit in the current account, could act as a pressure point on foreign reserve withdrawals. Despite the prospect of fiscal deficits in coming years, we view the Kingdom's credit profile as fundamentally solid, and should provide enough room for a gradual fiscal consolidation. We mainly view the current and planned initiatives announced in the 2016 budget to be pointing towards more efficient expenditure controls and revenue diversification. This will enable proper utilization of the fiscal buffers built over the previous years.

As interest rates rise, this bond issuance will present SAMA with an additional monetary policy tool to manage the day-to-day liquidity in the system. We don't see the sovereign bond issuances during 2016 to have a crowding out effect on bank credit to the private sector,

Figure 6: Holders of government bonds

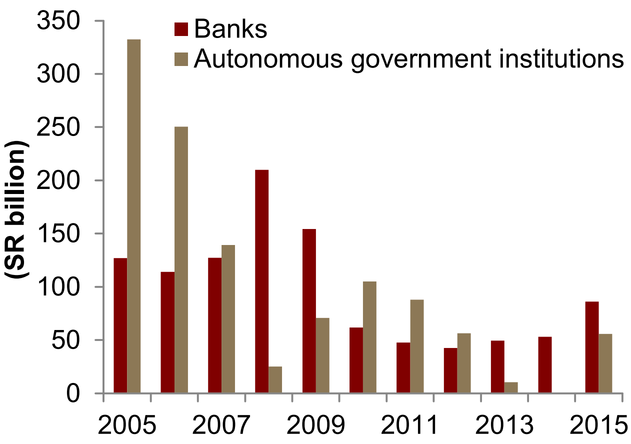
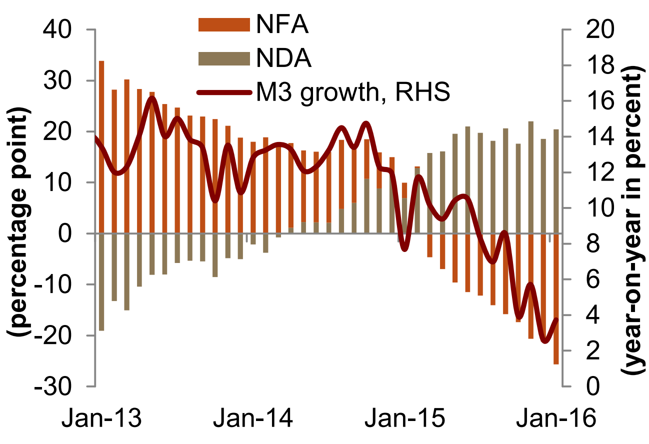


Figure 7: Contribution of credit and NFA to M3



We don't see the sovereign bond issuances during 2016 to have a crowding out effect on bank credit to the private sector...

... in the banking system is SR356 billion as of January 2016…

...lower than the SR448 billion estimated figure for the same period in 2015...

...but sufficient to finance part of the fiscal deficit in the medium-term.

since domestic liquidity is sufficient. We do, however, believe that such issuances would have implications on liquidity in the financial system if continued for a prolonged period of time.

It is worth noting that the absence of liquid markets for tradable bonds in the kingdom means that the banking system would be faced with lower liquidity as the bond issuances rise. According to Basel's liquidity coverage rules (LCR), sovereign debt can only be classified as a high quality liquid asset (HQLA) with zero percent risk weight if it satisfies a set of conditions, one of which is that assets should be traded in large, deep, and active markets. However, since the Kingdom's bonds are of a high quality, and SAMA's criterion of these bonds as re-purchasable (repo-able), a reproduction of the standards has been generally agreed between SAMA and the Basel Assessment Team. This reproduction of rules allows banks to hold an unlimited amount of government bonds without risking lowering the quality of assets held by banks.

We estimate the availability of excess liquidity in the banking system at SR356 billion as of January 2016, which is lower than the SR448 billion estimated figure for the same period in 2015 (Figure 5). We view this excess liquidity as sufficient to finance part of the fiscal deficit in the medium-term if the government continues with its current trajectory of bond issuance and reserve withdrawals. In the event of pressure on liquidity, we expect SAMA to allow other types of investors to participate in bond purchases, such as investment companies, insurance firms, and family offices. This would eventually broaden the fixed income playing field in the Kingdom, and can be looked at as a precursor to establishing a benchmark yield curve for an active and liquid domestic bond market. However, this may squeeze liquidity in the economy if continued beyond 2016, which would push the government to issue debt in foreign currency. Also, developing an active debt capital market in the Kingdom is unlikely given that SAMA is not following best practices in issuing sovereign development bonds.

Total claims on the public sector (excluding SAMA bills) makes up only 8.3 percent of total bank claims, which is very small compared to the high point of 45.8 percent reached in 2003. Apart from financing the budget deficit, we see this issuance providing an additional source of stable income for banks to diversify their loan portfolios and reduce overall credit risk and exposures in the current period of rising interest rates. Looking ahead, we believe that the government will continue to keep a check on the liquidity in the

Figure 8: SAMA FX reserves and Brent oil prices

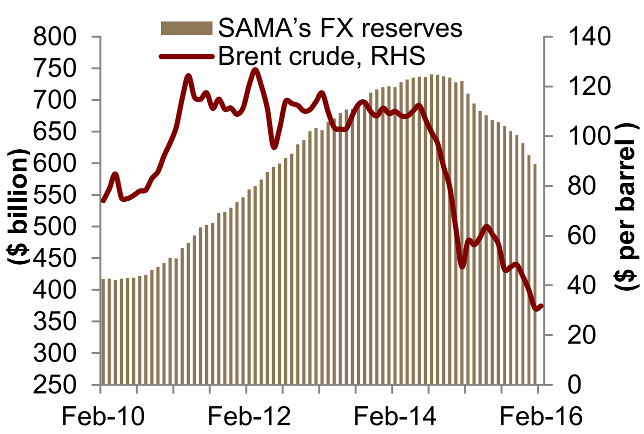
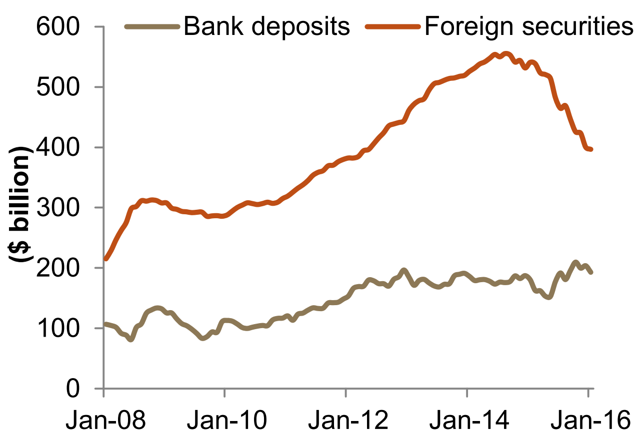


Figure 9: Main components of FX reserves



banking system as it balances between reserve withdrawals and debt issuance to finance the deficit in the coming few years.

Net Foreign Assets declined by $17 billion in January 2016

The Kingdom's system-wide NFA, fell by $17 billion in January...

...with the majority of the fall coming from SAMA's NFA.

The Kingdom's system-wide Net Foreign Assets (NFA), which includes NFA for both SAMA and commercial banks, fell by $17 billion in January, and follows a $97.7 billion decline in 2015 to reach $652 billion. The majority of this fall came from SAMA's NFA, which continued to constitute 91 percent of total NFA as of January. Meanwhile, commercial banks reduced their NFA by $2.4 billion in January. As for the implication on growth in monetary aggregates, the fall to NFA was countered by a rise in Net Domestic Assets (NDA), reducing the extent of the slowdown in the money supply (Figure 7).

Foreign exchange reserves fell by $14 billion over the month to reach $598 billion in January.

FX reserves continued to be impacted by falling oil prices…

...with Brent averaging $38pb and 31pb in December and January respectively.

SAMA's NFA continued to face downward pressure in January. Foreign exchange reserves fell by $14 billion over the month to reach $598 billion in January, compared to net additions of $1.5 billion and $2.5 billion during the same period in 2014 and 2015 respectively. FX reserves continued to be impacted by falling oil prices, with Brent averaging $38 per barrel (pb) and 31pb in December and January respectively (Figure 8). The Kingdom's oil output remained at near record levels in January, with exports rising to around 7.5 mbpd in December. Looking ahead, we see more issuances of domestic sovereign debt to keep the pressure off foreign reserves in financing the fiscal deficit, but there is a risk stemming from the deficit in the current account, which could act as a pressure point on foreign reserve withdrawals.

Within SAMA's foreign exchange reserves, deposits with foreign banks fell by $11 billion in January...

...while investment in foreign securities fell by $3.5 billion.

Within SAMA's foreign exchange reserves, deposits with foreign banks fell by $11 billion in January. This decline was likely due to a transfer of funds to the domestic economy for direct spending. Investments in foreign securities fell by $3.5 billion in January. These investments recorded a notable fall of $131.4 billion during 2015. This was steeper than the fall in the overall stock of reserves during 2015, meaning that a considerable amount of these investments was reallocated to deposits with foreign banks (Figure 9). This reallocation of funds have caused the share of reserves with foreign banks to increase from 25.6 percent during the beginning of 2015 to 32 percent of total reserve assets in January 2016. We view this as SAMA's preference to hold more liquid assets abroad in order to meet the financing needs of the government.

Figure 10: USD/SR 1-year forward rate

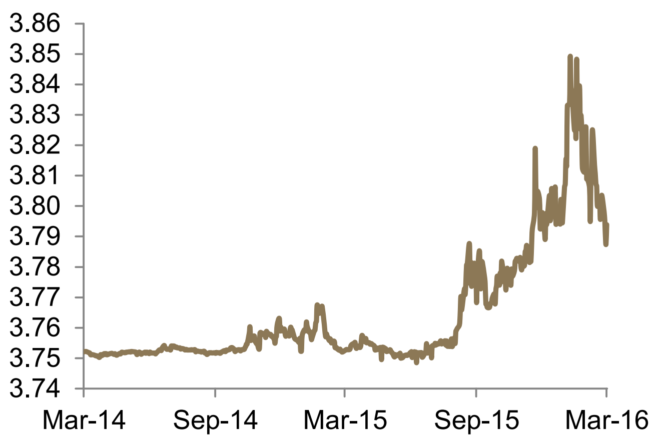
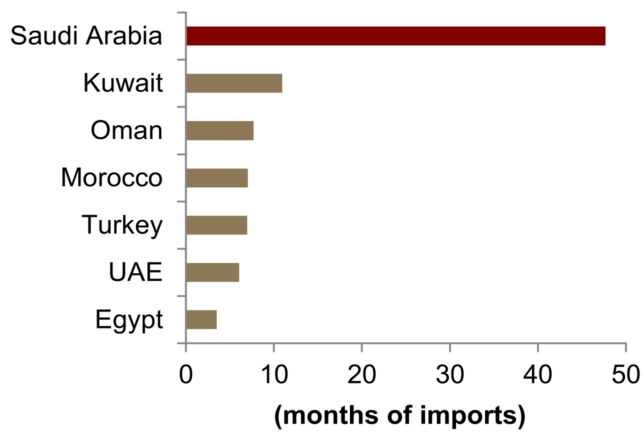


Figure 11: Foreign reserves import coverage



We do not see a likely devaluation to the Saudi Riyal given several reasons, including:

Speculative trading in response to the fall in foreign exchange reserves has pushed up the 1-year forward US Dollar/ Riyal rate to 3.85 in mid-January, before falling to 3.80 in March following SAMA's intervention to limit forward trading options at domestic banks (Figure 10). However, we do not see a likely devaluation to the Saudi Riyal given the still large cushion of foreign currency at SAMA's disposal. We expect SAMA to maintain the fixed exchange rate. This is due to three fundamental reasons:

i) economic incentives…

i) The economic incentive for the Kingdom is to keep the peg: Even in a period of low oil prices and twin deficits, a devaluation to enhance exports and government revenue is not likely to happen, since the Kingdom's main export, oil, is a commodity that is inelastic to changes in exchange rates, and is not likely to be boosted as a result of a Riyal devaluation. Further, a devaluation will cause a rise in the cost of imports, which will likely absorb all the extra money that would be enjoyed by the government, particularly if the government's purpose of a devaluation is intended to increase public spending.

….ii) high import coverage…

ii) Foreign reserve import coverage still at very comfortable levels: Foreign reserve assets can still cover up to 45 months of imports. This is very high by international standards. Putting this into context, Kuwait, Oman and the UAE have an import coverage of 11, 8, and 7 months respectively (Figure 11). A high coverage ratio should significantly enhance an economy's ability to withstand external shocks, therefore reducing the chance and impact of speculative pressure on its currency.

...and iii) reliance on gross actual settlements.

iii) Gross actual settlement (as opposed to net settlement): Given that the Kingdom enjoys a very large NFA position (100 percent of GDP), SAMA can easily require counterparties speculating against the Riyal to make payments in Riyals in order to take delivery of their forward Dollar purchases. This ability, combined with SAMA's full control over the supply of Riyals, can prevent the development of an offshore Riyal market, and reduce the impact of speculative pressure to a bare minimum.

Looking ahead, we estimate SAMA's foreign exchange reserves to reach $500 billion by the end of 2016.

Looking ahead, we estimate SAMA's foreign exchange reserves to reach $500 billion (SR1,874 billion) by the end of 2016, compared to $598 (SR2,241 billion) in January 2016. This is consistent with our view that the Kingdom will run a budget deficit of SR402 billion, a current account deficit of $72 billion, and total new debt issuance of SR120 billion. We also expect a likely continuation of this dual

Figure 12: Bank holdings by asset type
(month-on-month change)

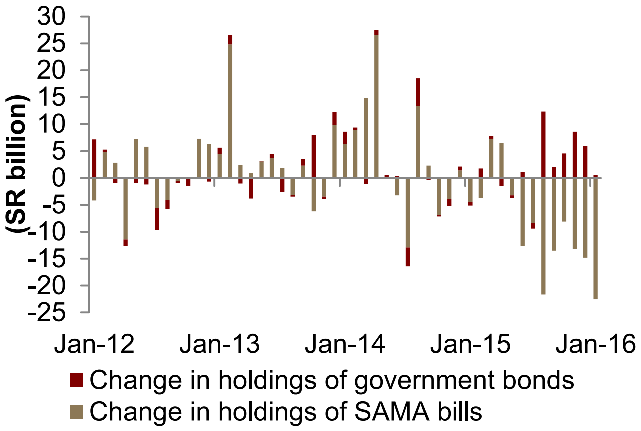
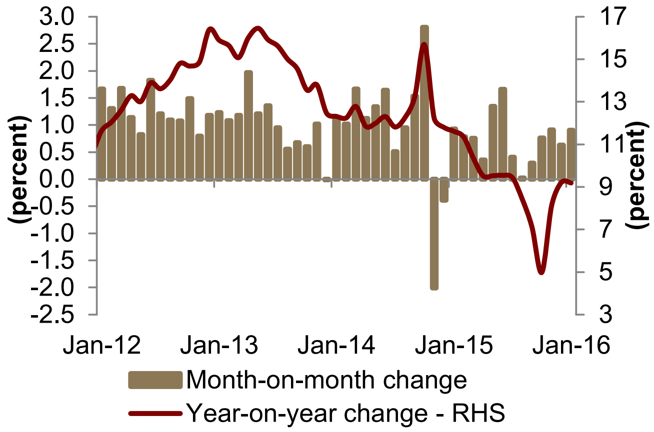


Figure 13: Credit to the private sector



On the domestic front, NDA increased in January by SR47 billion…

...mainly owing to a decline in government deposits in the domestic economy.

Monetary and banking data came out positive but showed a slowing trend during 2015...

...however, we see a likely moderation in the pace of this slowdown during 2016.

M2 growth slowed to 3.1 percent, year-on-year in January…

...mainly impacted by negative year-on-year growth in demand deposits.

financing strategy in 2017, with a potential for the government to tilt more towards debt issuance.

On the domestic front, Net Domestic Assets (NDA) increased in January by SR47 billion, continuing a very strong growth over 2015 to reach SR381 billion. NDA increased rapidly because of a decline in government deposits in the domestic economy, which fell by SR35 billion in January. NDA is measured as net of government deposits because the government has easier access to credit than other sectors, so that its expenditure is not usually constrained by its deposits or cash balances. During the year, banks' liquidity position fell, but remained at comfortable levels. As we mentioned earlier, our measure of bank holdings of excess liquidity (the sum of SAMA bills, net foreign assets, and excess reserves) stood at 356 billion in January. While this trend has led to a slowing growth in credit to the private sector, we believe that banks will continue to deploy more funds into the economy, with risks tilted towards the downside. The negative sentiment associated with lower oil prices will likely play a role, and any further delays to structural economic reform could also impact credit to the private sector.

Slowdown in monetary aggregates to moderate in 2016

Monetary and banking data came out positive but showed a slowing trend during 2015. This performance is reflected by the growth in the broad measure of money (M3), which reached 2.6 percent in 2015, the slowest since 1999, before rising slightly to 3.7 percent in January. While this is consistent with our view that the prospect of deterred capital spending by the government should lead to a slowdown in most monetary indicators, we see a likely moderation in the pace of this slowdown during 2016. The current series of sovereign bond issuances should reassure investors of the government's commitment to maintain a high level of spending on the economy. Nevertheless, the psychological impact of this deterrence would still mean that the slowdown will persist in 2016.

The narrower M2 measure, which includes demand deposits, time and savings deposits, currency outside banks, slowed to 2.5 percent in 2015 compared to 14.6 percent in 2014, before rising to 3.1 percent in January. Negative year-on-year growth in demand deposits at –1.3 percent, and –0.1 percent in December and January respectively pushed down the M2 measure. The growth of the monetary base, the most liquid measure of money, slowed to 3.7

Figure 14: Net new credit by kind of activity

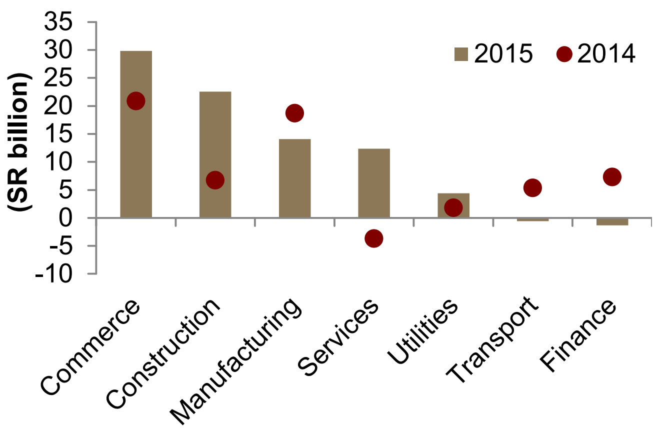
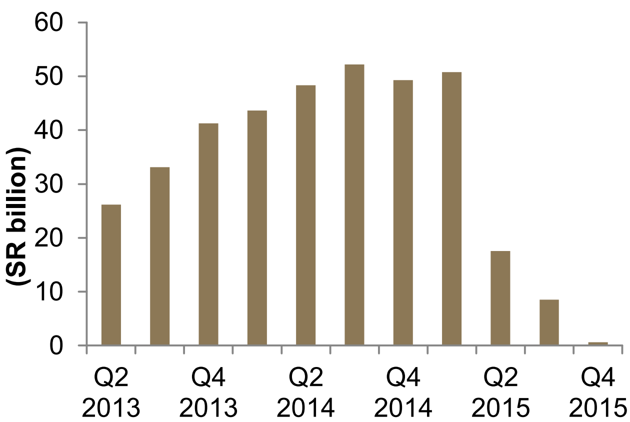


Figure 15: MOF approved construction contracts



In January, bank holdings of SAMA bills continued its sharp fall, dropping by SR22.5 billion.

Banks could be selling these bills to i) hold newly issued government bonds, ii) counter the slowing growth in deposits, and iii) step up the accumulation of NFA.

In January, year-on-year growth of bank claims on the private sector slowed but remained resilient.

percent year-on-year in January, down from 9.5 percent during the same period in 2015. The continued expansion –albeit at a slower pace– of money indicates that liquid money continues to be deployed in the economy. In January, currency outside banks grew by 6.7 percent year-on-year, slowing from an average of 12.7 percent for the previous twelve months.

In January, bank holdings of SAMA bills continued its sharp fall, dropping by SR22.5 billion month-on-month (SR108 billion year-on-year) to reach SR114 billion. We see this fall in line with the move by domestic banks to sell SAMA bills in order to free up liquidity and hold newly issued government bonds. Sovereign debt issuance to domestic banks, rose on a net basis by SR32 billion during the second half of 2015, with the January 2016 net issuance to banks being small at SR517 million (Figure 12). Banks could also be selling these bills to counter the negative impact on liquidity stemming from slower growth in deposits. That said, we believe the fall in SAMA bills during 2015 was also due to banks stepping up their accumulation of foreign assets to seek higher returns as more uncertainty clouded domestic credit conditions.

<u>Slowing but resilient credit growth to the private sector</u>

In January, year-on-year growth of bank claims on the private sector (excluding investments in securities) showed a slowing trend compared to the average for the previous five years but remained resilient. Year-on-year growth in credit to the private sector stood at 9.9 percent in January, up from 9.8 percent in December but slower than 11.7 percent during the same period in 2015. Year-end 2015 data showed that corporate credit slowed from 12.8 percent to 10.8 percent. This is in line with our expectations, as we forecast credit growth to further slow during 2016, putting the full year expansion in credit at 6 percent. In month-on-month terms, average growth in credit was 0.7 percent during 2015, compared with 0.9 percent in 2014 (Figure 13). We see that this trend is consistent with our view that the slower growth in private sector activity is translating into lower expansion in credit. 2015 data on non-oil private sector GDP already pointed to a slowdown, with 3.7 percent annual growth, compared to 5.7 percent in 2014.

The recent hike to the policy reverse repo rate in December is likely to also have a negative impact as credit becomes more expensive. However, previous incidences show that interest rate pass-through

Figure 16: Consumer credit

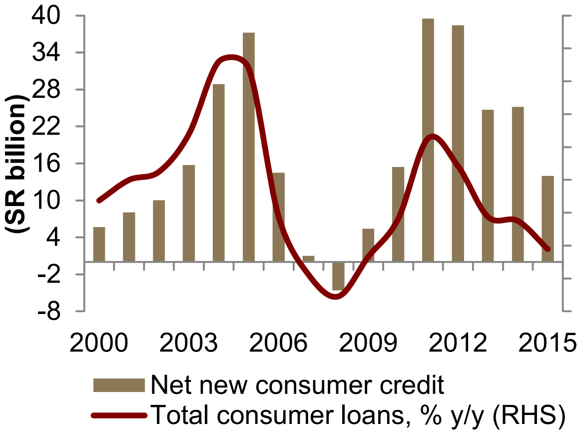
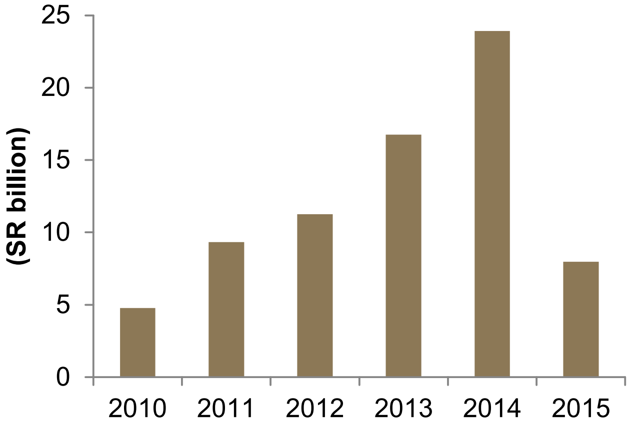


Figure 17: Residential real estate lending



We think that demand for credit by the private sector will increase…

...as corporations seek liquidity to manage their cash flows while the government moves towards an accommodative fiscal policy.

Net new credit was higher, year-on -year towards commerce, construction, services, and utilities.

Net new credit was also positive to manufacturing and mining, but came out lower than 2014.

Transport and finance saw a decline in net new credit issued during 2015.

The construction sector received SR22.5 billion in net new credit during 2015…

...significantly higher than the SR6.7 billion in 2014.

effects have been minimal on demand for credit. The growth in credit is likely to be more affected by the gradual consolidation in government spending and general sentiment regarding the ongoing economic reform than the increase in the reverse repo rate. In addition, we think that demand for credit by the private sector will increase as corporations seek liquidity to manage their cash flows while the government moves towards an accommodative fiscal policy. Meanwhile, banks should benefit from wider profit margins associated with higher interest rates. In nominal terms, net new credit rose by SR118 billion year-on-year in 2015, compared to SR128 billion in 2014. Within the private economy, net new credit was higher, year-on-year towards commerce, construction, services, and utilities. Net new credit was also positive to manufacturing and mining, but came out lower than 2014. Transport and finance saw a decline in net new credit issued during 2015.

Net new credit issued to the commerce sector stood at SR29.8 billion, posting a healthy rise compared to the same period in 2014, when net new credit reached SR20 billion. Trade and commercial activity amongst businesses continued to grow in line with the growth in the non-oil private economy. Commerce is a broad definition of all activities and business transactions that include the trade and exchange of goods and services between businesses or individuals, which partly reflects why credit to commerce is very high compared to other sectors.

The construction sector continued to be one of the largest recipients of new credit, receiving SR22.5 billion in 2015, significantly higher than the SR6.7 billion in 2014. We think that the main factor leading to the rise in credit was that demand for credit by the construction sector increased as contractors needed liquidity to manage their cash flows while the government started deterring its capital spending. The value of approved construction projects by the Ministry of Finance reached SR583 million in Q4, sharply down from SR49.3 billion during the same quarter in 2014 (Figure 15). The higher credit to the sector came along with positive earnings results for construction companies listed on Tadawul, as indicated by the 105.7 percent year-on-year rise in the sector's annual income during 2015. We believe that recent news sources pointing to delays and cancellations in construction projects will have a negative impact on the outlook of the construction sector, and therefore expect a lower value of new credit extended by banks.

Figure 18: Growth in total bank deposits

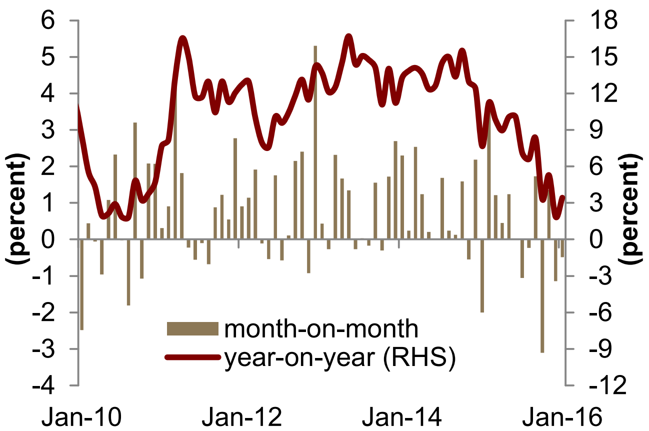
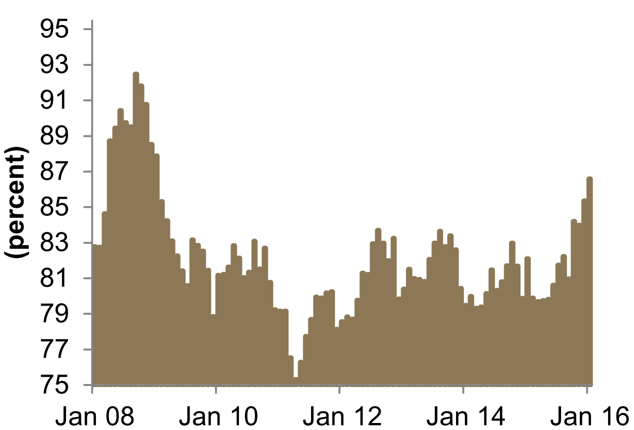


Figure 19: Loan-to-deposit ratio



Weaker world prices for basic materials continued to impact profit margins of Saudi manufacturers.

Weaker world prices for basic materials continued to impact profit margins of Saudi manufacturers. 2015 annual income for listed petrochemicals on Tadawul fell by 38 percent. This reflects the higher risks and lower attractiveness for credit expansion to the sector. Further, credit to the manufacturing sector constitutes 58 percent of the sector's annual GDP, which means that any reduction in credit would have a significant impact on the prospects for the sector. Nevertheless, we see that significant capacity additions and the continued expansion of the sector will result in growth in credit to the sector during 2016.

The electricity and water sector was the recipient of the fourth highest value of new credit.

The electricity and water sector was the recipient of the fourth highest value of new credit, at SR4.4 billion, higher than the SR1.8 billion received during 2014. Large-scale investments in long-term electricity and water projects to meet growing demand have meant that new credit continued to be directed to that sector. We believe that banks will continue to extend new credit to the electricity & water sector as the growth prospects for this sector remain positive and least impacted by the potential cuts in government capital spending.

Net new credit issued to the finance and transport sectors was negative…

...reflecting a slowing trend in government capital spending and a generally more inhibited lending environment to financial corporations.

Net new credit issued to the finance and transport sectors was negative, reflecting a slowing trend in government capital spending and generally more inhibited lending environment to financial corporations. Looking ahead, we think that the demand for credit will remain high in these sectors, but the negative sentimental impact will continue taking its course, with a possibility of further declines in credit during 2016.

Consumer credit growth slows markedly

Data on consumer credit showed a notable slowdown during 2015…

...with year-on-year growth of bank credit to consumers slowing to 4.5 percent in 2015…

...down from 8.8 percent during the previous year.

Data on consumer credit showed a notable slowdown during 2015. Year-on-year growth of bank credit to consumers have slowed to 4.5 percent in 2015, down from 8.8 percent in 2014. In nominal terms, net consumer credit rose by SR13.8 billion in 2015, compared to SR25.2 billion in 2014 (Figure 16). We view the slowdown in consumer credit as mainly due to the broader slowdown of bank credit towards the private sector during 2015, rather than a reorientation of bank credit towards corporations, since consumer credit still enjoys about the same share of total credit it did a year ago at 24 percent. The year-on -year slowdown was also impacted by the regulations on consumer lending by SAMA during the first few months of 2015. The new regulations include caps on bank fees, in order to further enhance the stability and strength of the financial system.

Figure 20: Loan-to-deposit ratio by bank

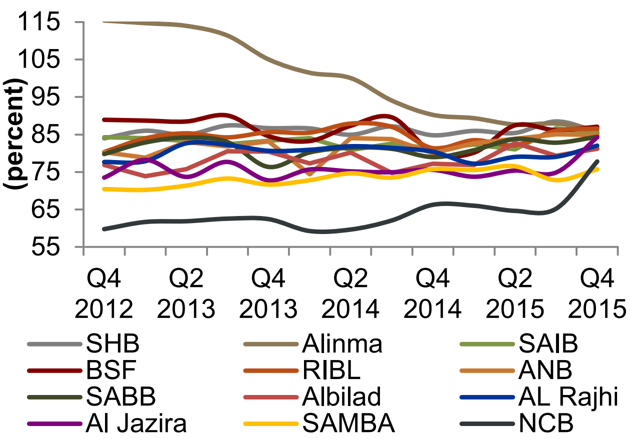
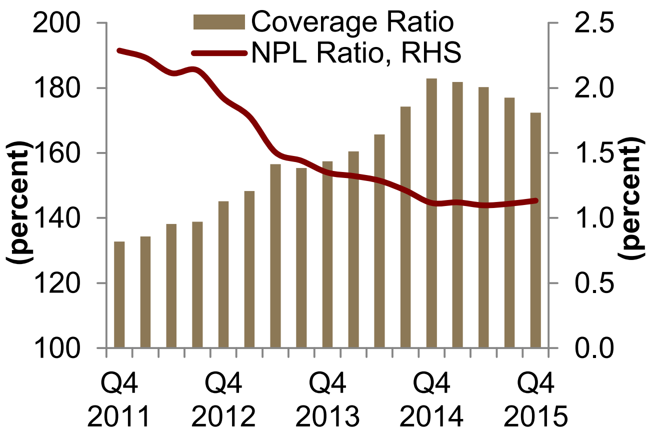


Figure 21: Coverage and NPL ratios



Net real estate loans for residential customers have also shown a slowing trend…

…but a recent amendment to real estate lending rules means that there is potential for growth in credit under this segment.

Net real estate loans for residential customers have also shown a slowing trend, as the impact of real estate lending regulations continued during 2015. Net new residential loans for real estate reached SR7.7 billion percent during 2015, significantly lower than SR24 billion in 2014 (Figure 17). Looking ahead, a recent amendment in credit rules by SAMA now allows beneficiaries to make a down payment of 15 percent (instead of the 30 percent requirement). The additional financing of 15 percent will be conditioned upon a guarantee by the Ministry of Finance to banks, which should encourage more activity in retail real estate lending in 2016 and beyond.

We expect annual growth in credit to the private sector to slow to 6 percent in 2016...

...down from 9.8 percent growth recorded in 2015.

We expect annual growth in credit to the private sector to slow to 6 percent in 2016, down from 9.8 percent growth recorded in 2015. Spending by the government will continue to be the growth driver for credit to both consumers and corporations despite the projected slowdown, while regional geopolitical risk and the external economic environment present downside risks on general market sentiment.

Growth in bank deposits and profits fall

Year-on-year growth in total bank deposits fell to 1.9 percent in December…

...its slowest since August 2010.

Year-on-year growth in total bank deposits fell to 1.9 percent in December, its slowest since August 2010, before accelerating slightly to 3.4 percent in January (Figure 18). Growth in private sector deposits slowed to 2.7 and 2 percent in December and January respectively. Year-on-year growth in government deposits reached 7.8 percent in January, returning to the positive territory following three consecutive monthly declines. The general slowdown in deposit growth relative to the resilience in bank credit pushed up the loan-to-deposit ratio to 86.1 in January, its highest in seven years. In an effort to ensure that credit activity remains resilient, SAMA actively responded by raising the lending cap on banks from 85 percent to 90 percent of deposits. Based on our estimates, this will make room for an additional SR63 billion in readily available credit to the private sector (Figure 19). All banks are positioned well to extend further credit from this easing (Figure 20). That said, we think that the resilience so far in credit growth is mainly due to the high levels of excess liquidity available with banks, which is ensuring a smooth adjustment in the credit extension process.

Banks posted negative year-on-year growth in profits for the first time since April 2013.

In January, banks posted negative year-on-year growth in profits for the first time since April 2013. Growth in bank profits was down by 3.7 percent, and was likely due to a recent uptick in bank provisions.

Figure 22: Bank FX sales to other customers in the Kingdom

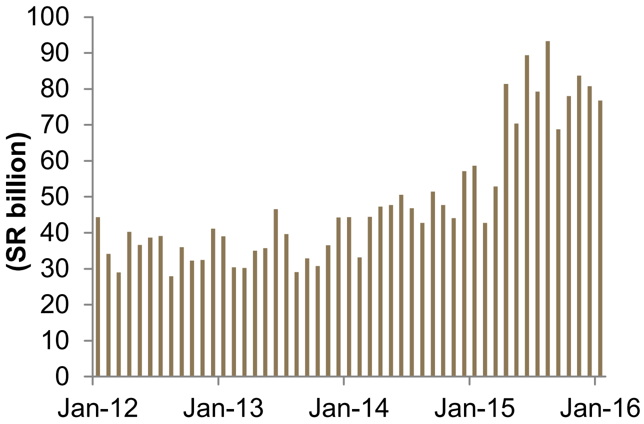
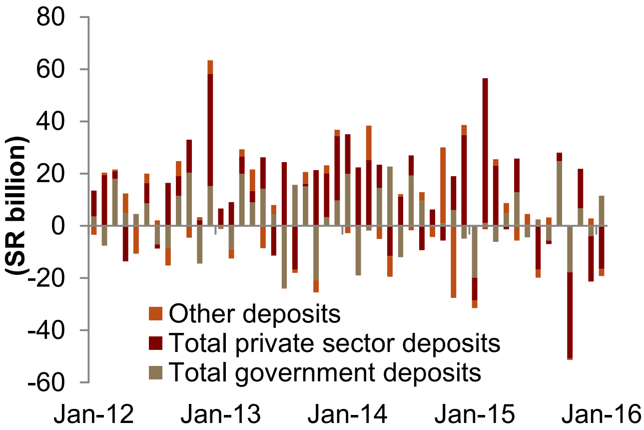


Figure 23: Deposits by institution
(month-on-month change)



During 2015 provisions rose slightly as banks took precautionary measures…

...but liquidity conditions remained stable as the coverage ratio declined only slightly.

During 2015 provisions rose slightly as banks took precautionary measures in anticipation of any increase in non-performing loans. However, liquidity conditions remained stable as the coverage ratio declined only slightly, while the ratio of non-performing loans to total credit was nearly unchanged at 1.1 percent towards the end of 2015 (Figure 21).

Looking ahead, we expect the performance of banks to continue at a weakening pace.

Looking ahead, we expect the performance of banks to continue at a weakening pace, as the rate of growth in credit is expected to trend downwards throughout 2016. Nevertheless, we expect banks to primarily benefit from higher interest rates on loans, while simultaneously being able to reduce overall risks through more diversified loan portfolios. Bank's portfolio diversification would include the continued accumulation of foreign assets as well as increased holdings of sovereign development bonds. These factors combined should result in bank credit remaining positive throughout 2016, as the sufficiently liquid banking system will provide room to counter any contraction in money supply.

Rising uncertainty could lead to another surge in capital outflow

We think FX sales played a role in causing slower growth in private sector deposits.

Previous surges in capital outflow are consistent with periods of financial uncertainty.

The announcement of the highly anticipated NTP is ever the more necessary…

...as it can contribute in reassuring investors of the government's commitment towards structural economic reform.

Despite the resilience and stability of the Saudi financial system, a recent surge in capital outflow had occurred; bank FX sales to "other customers" in the Kingdom rose notably in the past few months, reaching SR89 billion in mid-2015, a 7-year high, before gradually falling to 77 billion in January (Figure 22). We think FX sales played a role in the slower growth in private sector deposits (Figure 23). Previous surges in capital outflow are consistent with periods of financial uncertainty (1998 Asian financial crisis, and the 2008 global financial crisis). However, this time, the surge in outflows seems to combine both global factors of financial volatility, rising domestic economic challenges, and geopolitical uncertainty. Also, the continued absence of a comprehensive agenda for economic reform makes it difficult to avoid another surge. This makes the announcement of the highly anticipated national transformation plan (NTP) ever the more necessary, as it can contribute in reassuring investors of the government's commitment towards structural economic reform, leading to a reduction in the extent of capital outflows and negative sentiment.