جدوى للإستثمار
Jadwa Investment

December 2016

Monetary and Financial Update

Rebound in Monetary Aggregates

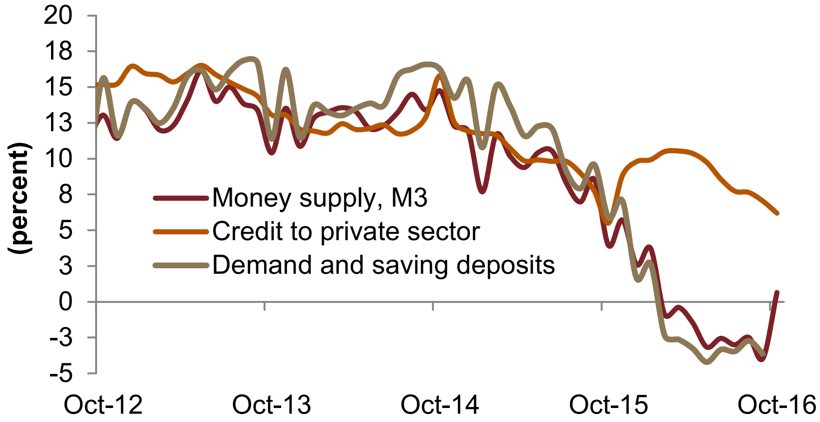
Key Indicators
Percent, year-on-year

Indicator	Oct 2015	Oct 2016
M3*	5.5	0.0
Credit to private sector	5.5	6.2
Claims on public sector	13.0	105.3
Total deposits	3.3	0.5
Loan-to-deposit ratio	83.7	89.1

* Note: M3 corresponds to November 2015 and 2016

- **Monetary Policy - Global:** Following the US Federal Reserve's (Fed) second rate hike since 2008, the US's path to policy normalization is expected to accelerate. Meanwhile, other advanced economies are expected to continue with their respective quantitative easing programs in 2017.
- **Monetary Policy - Domestic:** The Saudi Arabian Monetary Authority (SAMA) has passed several measures to enhance liquidity in the domestic financial system, which has contributed to lowering the cost of funding.
- **Money Supply:** Growth in money supply has rebounded in recent months, benefiting from higher deposits as a result of a resumption of government payments to the private sector.
- **Claims on the Public Sector:** Following the international sovereign bond program, in October 2016, domestic banks have seen a modest rise in their claims over the public sector.
- **Credit to Private Sector:** Sentiment will play an increasingly significant role in determining growth in private sector credit during 2017, particularly following tightening liquidity that persisted before October.
- **Sectoral Credit**: Within the private sector in Q3 2016, net credit was higher, year-on-year towards commerce and agriculture.
- **Financial Soundness:** The financial system is still liquid and can provide room to finance both the public and private sectors, but with sentiment playing a key role.
- **Capital Outflows:** The surge in net capital outflows that pushed down FX reserves at the beginning of 2016 moderated in Q2 and Q3 2016, mainly due to an improvement in both the current account and the non-reserve financial account.

Figure 1: Money supply, bank credit, and deposits
(year-on-year change)



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Global monetary outlook

A strengthening US economy resulted in the Fed raising the FFR in by 25 basis points...

...with a potential for a faster pace of rate hikes if fiscal policy brings more stimulus in 2017.

The sharp rise in US Treasury yields following the elections reflects heightened expectations of an expansionary fiscal stance in the US. This development, along with an uptick in inflation, and an already strengthening labor market, resulted in the Fed raising the Federal Funds Rate (FFR) in mid-December 2016 by 25 basis points (bps), its second such hike since 2008. We see recently released economic data, including US unemployment rate falling to pre-2008 levels, pushing the Fed to continue with its gradual tightening cycle. The potential for a faster pace of rate hikes is positive if fiscal policy brings more stimulus in 2017. Latest survey data shows a 57.3 percent probability of at least two additional US interest rate hikes, by 25bps each during 2017 (Figure 2).

That said, risks linked to excessive monetary tightening could push up borrowing costs for corporates in the US, 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 Q2 2016, the majority of which is held within the shale oil industry.

A higher pace of US interest rate hikes could have negative effects on global financial markets.

Under these circumstances, many emerging markets are running the risk of also having to raise interest rates in order to maintain a strong currency, and limit the impact of potential currency crises. Countries with high US Dollar denominated debt such as Turkey and South Africa stand out. Higher US interest rates could also have negative effects on global financial markets, similar to what happened at the beginning of 2016 when the FFR hike, coupled with fears of an economic slowdown in China, led to turmoil in global equity markets. In November, net portfolio flows to emerging markets have shown their third largest outflow since the global financial crisis (Figure 3); possibly due to the anticipated FFR hike, but it may also reflect rising concerns over the outcome of US elections.

Meanwhile, other advanced economies in 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. Whilst these economies are expected to extend their quantitative easing programs through 2017, any notable rise in inflation could signal a start of some form of tapering.

Figure 2: Probability of US interest rate rises
(survey of expected rise in FFR in basis points by date)

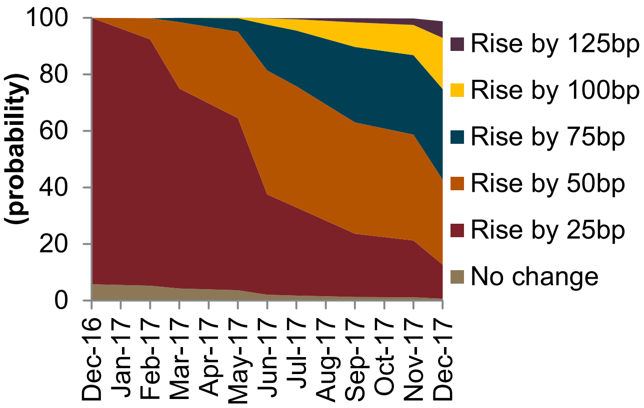
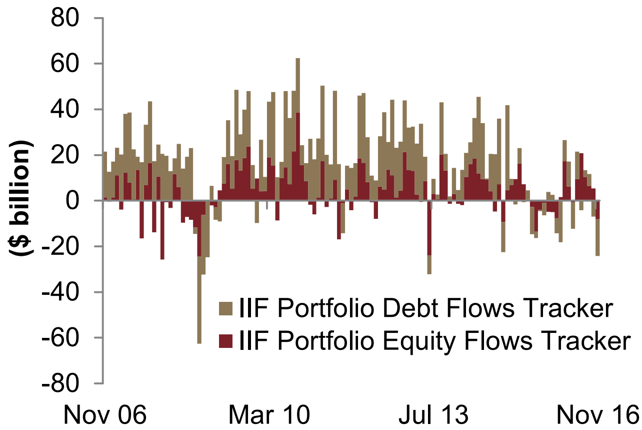


Figure 3: Portfolio flows into emerging markets



Saudi monetary and financial outlook

Recently passed measures to enhance liquidity…

In December 14, 2016, the Saudi Arabian Monetary Authority (SAMA) increased its reverse repo policy rate by 25bps to 0.75 percent, its second such increase since 2008, mirroring the hikes in the US. Meanwhile, SAMA's key policy repo rate was kept unchanged at 2.0 percent. SAMA's rate increase and the prospect of further Fed hikes in 2017 will not have a significant impact on the domestic liquidity situation. This is specifically due to SAMA recently passing several measures to enhance liquidity in the domestic financial system. In September, SAMA introduced new 90-day repos, as well as capped the weekly issuance of SAMA bills to SR3 billion, down from SR9 billion previously. SAMA has also recently approved changes to calculate the Saudi Interbank Offer Rate (SAIBOR) more appropriately (See box 1). These changes, along with the international bond issuance, and the resumption of payments by government to contractors, as per an official announcement made in October, have contributed to halting the rise in the cost of funding. The SAIBOR has started to decline, and annual growth in deposits and broad money supply turned positive in October for the first time in 2016 (Figures 4 and 5).

...and the resumption of delayed payments by the government...

...have contributed to halting the rise in the cost of funding.

The impact from the resumption in government spending is already being reflected through a recent rebound in growth of monetary aggregates. Growth in monetary aggregates have also been made possible through the substitution of monthly domestic sovereign bond issuances (SR20 billion per month since June 2015) with a $17.5 billion international sovereign bonds in October 2016. As a result, monetary aggregates have showed a recovering trend in recent months, confirming our earlier view that the prospect of international borrowing will lead to an improvement in domestic liquidity conditions. That said, we believe this trend will continue over the remainder of 2016.

We expect SAMA's key policy repo rate to be raised by 0.50 percentage points in 2017, mirroring the anticipated Federal Funds rate hike. However, as mentioned earlier, we do not expect this policy move to have a material impact on liquidity levels, deposit growth, or significant movements in market rates.

<u>Growth in domestic claims on the public sector likely to slow</u>

We expect the government to continue issuing sovereign bonds to domestic banks and other public institutions in 2017, but in smaller

Figure 4: Market rates

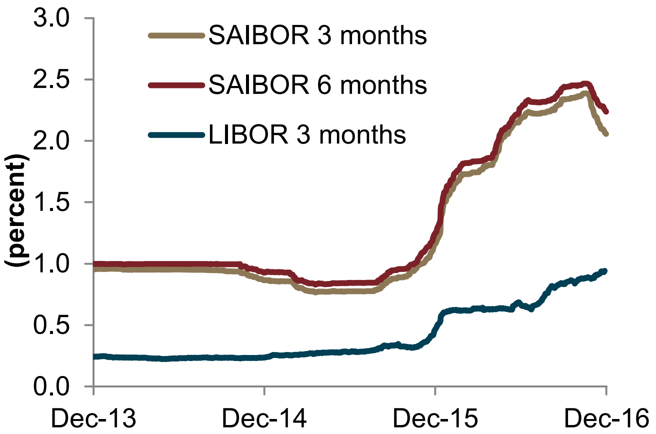
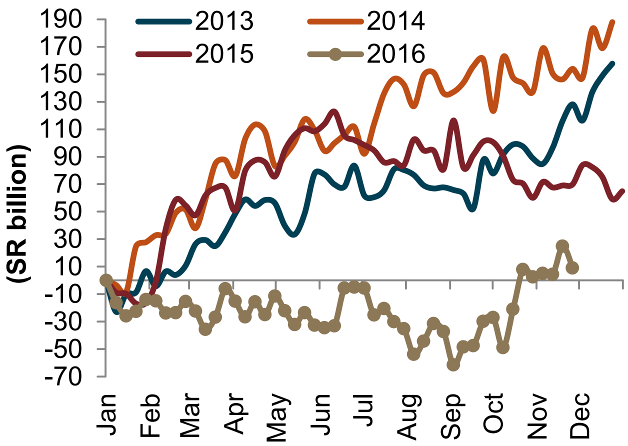


Figure 5: Broad money supply (M3)
(weekly data, year-to-date)



We expect the government to continue issuing domestic bonds in 2017…

...but in smaller quantities.

quantities compared to the SR20 billion ($5.3 billion) series of monthly issuances between June 2015 and September 2016. While the previous series of issues had a significant impact on reducing excess bank liquidity, maintaining a domestic issuance with reasonable amounts is nevertheless necessary to establish a benchmark yield curve. Allowing corporates to price their issuances would therefore enable a liquid fixed income market within the Kingdom.

Box 1: Aligning the SAIBOR with IOSCO principles

SAMA recently mandated Thomson Reuters to calculate the SAIBOR.

In an effort to comply with the International Organizations of Securities Commission (IOSCO) principles for financial benchmarks, SAMA recently mandated Thomson Reuters to calculate the SAIBOR. This can better reflect the actual funding environment in the Kingdom. SAIBOR was calculated earlier by an individual bank and this transformation will allow for better governance, accountability, and transparency of rate setting.

Table 1. IOSCO principles

Governance	**Benchmark quality**
Overall responsibility	Benchmark design
Oversight of third parties	Data sufficiency
Conflict of interest	Hierarchy of data inputs
Control framework	Transparency
Internal oversight	Periodic review
Quality of methodology	**Accountability**
Content	Complaints procedures
Changes	Audits
Transition	Audit trail
Submitter code of conduct	
Internal controls over data	

The IOSCO principles are aimed to create an overarching framework for benchmarks used in financial markets.

The IOSCO principles are aimed to create an overarching framework for benchmarks used in financial markets. With the goal of promoting transparency, openness, and the reliability of benchmark determinations, these principles address conflicts of interest in the benchmark-setting process (Table 1).

In late November, the Ministry of Finance -through its recently established debt management office- stated that it will resume the local debt issuances in 2017. It also said that it is working on

Figure 6: Breakdown of public debt

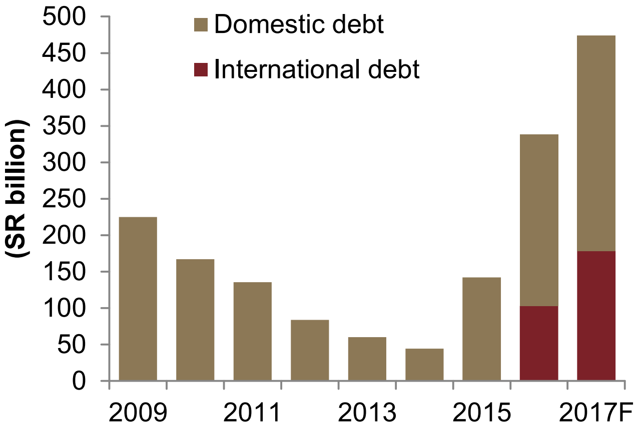
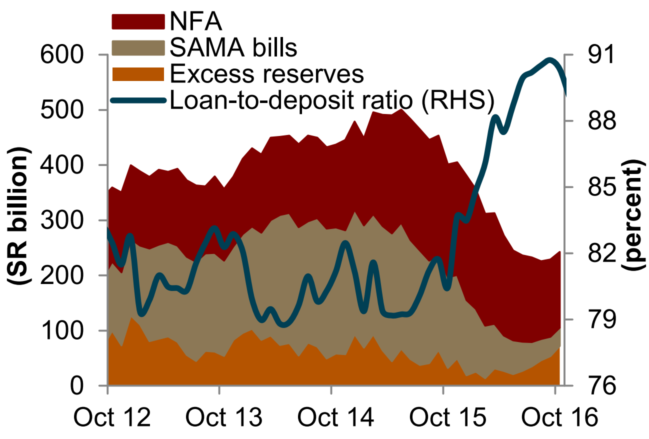


Figure 7: Estimate of bank excess liquidity



Domestic bank holdings of government bonds rose by SR89.6 billion, year-to-October.

We forecast total public debt to reach SR338 billion by the end of 2016…

...with 70 percent of this being domestic debt.

We view bank excess liquidity as sufficient to finance part of the fiscal deficit in the medium-term.

developing a primary debt market, diversifying debt instruments through local and international Sharia compliant Sukuk issues, and the developing the secondary debt market by registering and listing existing and new local debt instruments on the TASI. We see all of these planned efforts as precedents to a liquid fixed income market over the next few years.

The year-to-October net increase in domestic bank holdings of government bonds reached SR89.6 billion (10.7 percent of 2016 budgeted spending). According to the Ministry of Finance, no domestic bonds were issued in October and November, as the government relied on its new $17.5 billion international sovereign bond issuance. This new series of sovereign bonds will be crucial in maintaining development spending on the economy whilst preserving both foreign reserves and domestic liquidity.

We expect the fiscal deficit to continue in 2017, with financing through a combination of reserve withdrawals and domestic and international sovereign bond issuances to persist. We forecast total public debt to reach SR338 billion (14.3 percent of GDP) by the end of 2016, with 70 percent of this being domestic debt (Figure 6). In 2017, we forecast total public debt to rise to SR474 billion (18.3 percent of GDP), with more international bond issuances likely to finance a narrower deficit next year.

As interest rates rise, a consistent and reasonable stream of domestic bond issuance will present SAMA with an additional monetary policy tool to manage the day-to-day liquidity in the system through buying or selling these bonds in open market operations. We also see the international sovereign bond issuance to have a positive and instant impact on domestic liquidity, leaving more room for domestic banks to continue operating without the risk of crowding out credit to the private sector. Our estimate of excess liquidity in the banking system showed a notable increase in October, rising by SR14 billion to reach SR245 billion, its fastest monthly increase since July 2014 (Figure 7).

We view SR245 billion in excess liquidity as sufficient to finance part of the fiscal deficit in the medium-term, if the government continues with its current trajectory of international and domestic bond issuance and reserve withdrawals. In the unlikely event of further 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

Figure 8: Contribution of credit and NFA to M3

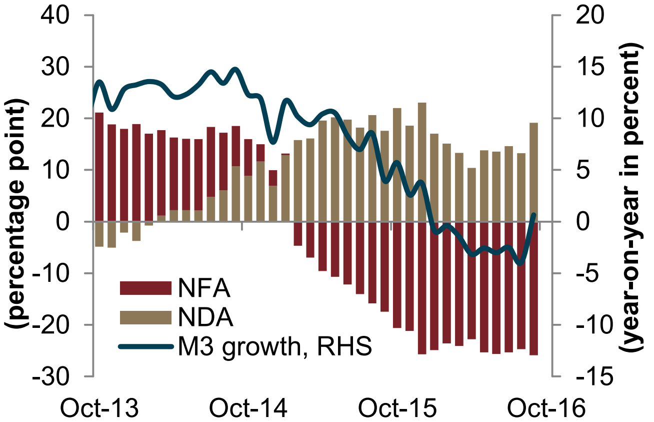
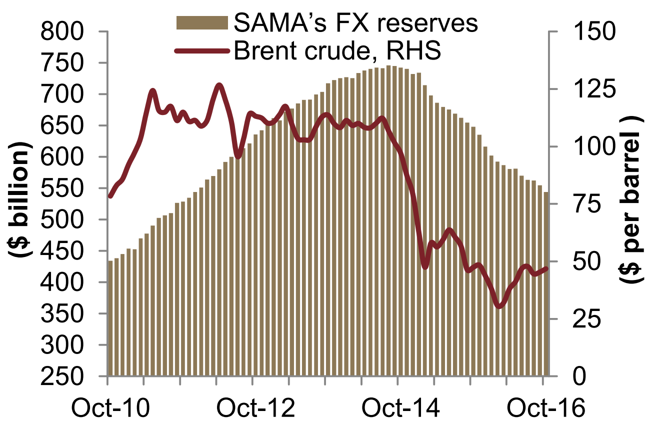


Figure 9: SAMA FX reserves and Brent prices



broaden the fixed income playing field in the Kingdom, and can be seen as a precursor to establishing a benchmark yield curve for an active and liquid domestic bond market, particularly since the Ministry of Finance is already intending to list its bonds on the Saudi stock exchange. That being said, developing an active debt capital market in the Kingdom is currently unlikely, given SAMA is still not following best practices with regards to disclosing the details of domestic sovereign bond issuances.

Bank claims on the public sector still make up only 13.3 percent of total bank claims.

Bank claims on the public sector (excluding SAMA bills) still make up only 13.3 percent of total bank claims, which is very small compared to the high point of 45.8 percent reached in 2003. Looking ahead, we believe that the government will continue to keep a check on the liquidity in the banking system as it balances between reserve withdrawals and domestic and international debt issuance to finance the deficit in the coming few years.

<u>Slowing pace of decline in Net Foreign Assets</u>

The Kingdom's system-wide NFA, fell by $97 billion, year-to-October.

The Kingdom's system-wide Net Foreign Assets (NFA), which include NFA for both SAMA and commercial banks, fell by $97 billion, year-to-October, compared with a similar net decline of $98 billion in 2015. The majority of this fall came from SAMA's NFA, which continued to constitute 94 percent of total NFA. Meanwhile, commercial banks reduced their NFA by $24 billion during the same period, compared with a net addition of $18 billion in 2015. A net decline in bank NFA, since the start of 2016, is most likely a liquidation of foreign assets to finance the purchase of government bonds. As for the implication on growth in monetary aggregates, the fall in NFA was generally larger than the increase in Net Domestic Assets (NDA), before NDA accelerated in October as a result of the liquidity injection from international bonds (Figure 8).

October FX reserves saw its third largest monthly decline in 2016, falling by $11 billion...

...reflecting the payment of accumulated dues by local contractors to foreign service providers.

SAMA's NFA continued to face downward pressure, year-to-October 2016. In October, FX reserves saw their third largest monthly decline in 2016, falling by $11 billion. The October FX reserve withdrawals came despite an improvement in oil exports, as Brent averaged $47 per barrel (pb) compared with $41pb year-to-September (Figure 9). Also, the likely addition to foreign currency as a result of the $17.5 billion international bond program did not seem to have been added to FX reserves in October, unless a very significant capital outflow was recorded during the same month.

We think the October decline in FX reserves partly reflects the

Figure 10: Fiscal spending, foreign income sources, and SAMA FX reserves

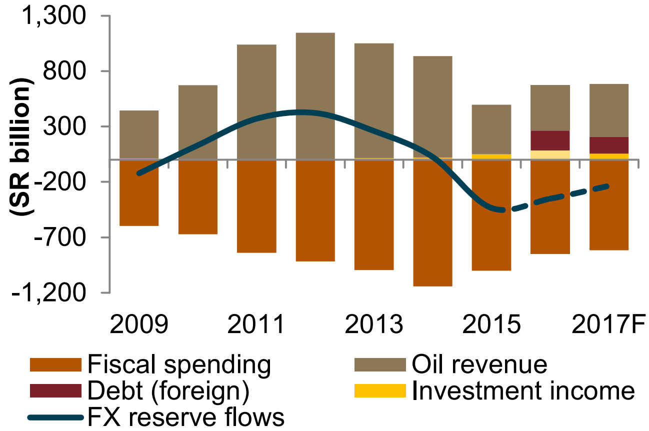
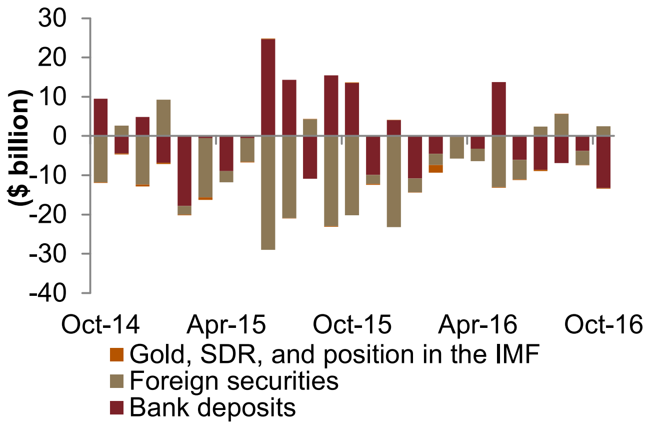


Figure 11: Main components of FX reserves (month-on-month change)



payment of accumulated dues by local contractors to foreign service providers as soon as the government resumed its payments during the month. It seems that government payments were instantly channeled out of the domestic economy. Looking ahead, we see more issuances of international sovereign debt, along with the new direction by the Public Investment Fund (PIF) to focusing on generating long-term income from international investment, to reduce the pressure on FX reserves (Figure 10).

Looking ahead, we see the SR100 billion transfer from government accounts with SAMA to the PIF in November to be reflected in FX reserves.

Within SAMA's foreign exchange reserves, deposits with foreign banks fell by $13.3 billion in October. Meanwhile, investment in foreign securities saw a $2.5 billion month-on-month rise (Figure 11). We think that the net addition to investments is a positive sign, since they can generate higher returns. Looking ahead, we see the SR100 billion transfer from government accounts with SAMA to the PIF in November to be reflected in FX reserves. This is because the foreign portion of the SR100 billion managed by SAMA will be transferred to PIF as well. This transfer will likely mean that FX reserves will no longer be the sole benchmark to which investors judge the strength of the kingdom's external buffers, but should take account of the broader international investment position. This includes foreign assets of other independent government organizations and funds, to make informed decisions regarding the Kingdom's external sustainability.

That said, speculative trading in response to the fall in foreign exchange reserves which pushed up the 1-year forward US Dollar/ Riyal rate to 3.85 at one point has now subsided. At the time of writing this report, it had reached 3.79, following several measures by SAMA to manage liquidity in the financial system and the recommencement of government payments (Figure 12). However, we do not see a likely devaluation to the Saudi Riyal given the still large cushion of foreign currency at SAMA's disposal, covering 66 months of goods imports as of October.

We estimate SAMA's foreign exchange reserves to reach $523 billion by the end of 2016.

Looking ahead, we estimate SAMA's foreign exchange reserves to reach $523 billion (SR1,961 billion) by the end of 2016, compared to $616 (SR2,312 billion) in December 2015. This implies lower net withdrawals over the remainder of 2016 as a result of the international bond issuance.

On the domestic front, Net Domestic Assets (NDA) increased by SR61 billion in October, continuing to show strong growth, to reach

Figure 12: SR/USD 1-year forward rate

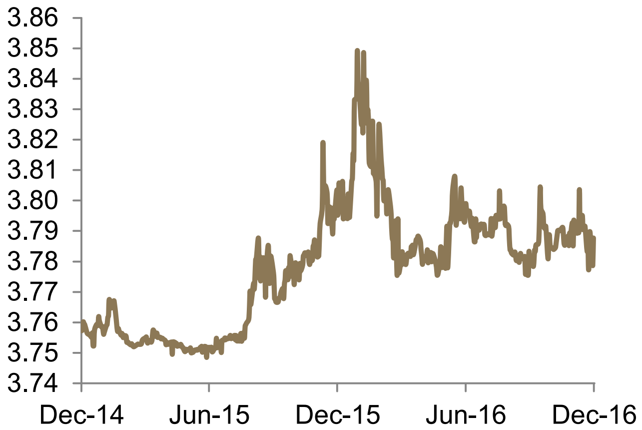
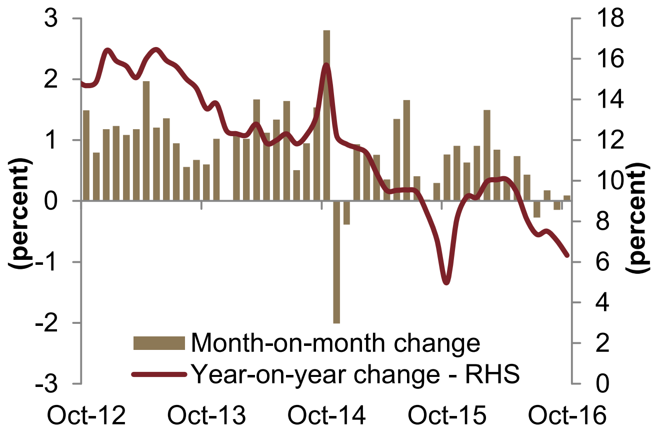


Figure 13: Credit to the private sector



SR711 billion. NDA increased rapidly year-to-October, rising by SR240 billion. This rise was mainly due to a decline in government deposits in the domestic economy, which fell by SR177 billion since the start of 2016. NDA is measured as net of government deposits because the government, in comparison to other sectors, has easier access to credit, so that its expenditure is not usually constrained by its deposits or cash balances.

We believe that banks will continue to deploy more funds into the economy…

...with risks tilted towards the downside.

During 2016, banks' liquidity positions 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 SR243 billion in October. While this trend has led to slower credit growth 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 further implementation of unanticipated costs on businesses and consumers as a result of fiscal consolidation, coupled with any further delays to other initiatives highlighted in the National Transformation Program (NTP 2020) could negatively impact credit growth to the private sector in coming months.

Growth in monetary aggregates turns positive but will stay low

Monetary indicators have shown signs of a rebound in October…

...owing to the recommencement of government payments to contractors.

Monetary indicators have shown signs of a rebound in October following a slowdown over the previous nine months. This performance is reflected by the positive annual growth in the broad measure of money (M3), which reached 0.7 percent in October. We view this as a direct result of the recommencement of government payments to contractors, and see a likely continuation of this recovery in the final month of 2016. The new series of international sovereign bonds, along with the resumption of the domestic program in 2017, should reassure investors of the government's commitment to maintain a high level of spending on the economy. Nevertheless, the psychological impact of the earlier deferral of payments would still mean that the monetary aggregates will not return to the double digit growth rates enjoyed over the decade ending in 2014.

Looking ahead, we see a likely continuation of this recovery in the final two months of 2016.

The narrower M2 measure, which includes demand deposits, time and savings deposits, and currency outside banks, rebounded to 2.7 percent in October, posting its first year-on-year increase since January. The largest monthly addition to private sector deposits since the start of 2016 (SR28 billion in October) pushed up the M2 measure. The growth of the monetary base, the most liquid measure of money, also rebounded to 0.4 percent year-on-year in October, up from -5.1 percent during the previous month. The recent expansion of money indicates that liquidity has been injected in the economy. Currency outside banks also rose to 2 percent year-on-year in October, compared with an average of 1.1 percent over the previous nine months.

In October, bank holdings of SAMA bills continued to fall, month-on-month, for the 18th consecutive month, reaching SR33.3 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. Furthermore, SAMA's decision to cap the weekly issuance of SAMA bills to SR3 billion, down from SR9 billion previously is another factor that is likely to pull down holdings of such bills. However, the extent of the monthly declines in bank holdings of SAMA bills showed a slowing trend in recent months as the government shifted towards international borrowing. Sovereign bond holdings by domestic banks rose by SR3 billion in October, compared with an average of SR9.7 billion per month, year-to-September. Banks could also be selling these bills to counter the negative impact on liquidity stemming from slower growth in deposits. That said, we believe that SAMA decision to cap the weekly issuance of bills indicates that the monetary authority will revert to other means to manage liquidity in the financial system, including the utilization of reserve requirements, loan-to-deposit ceilings, and capital adequacy.

Slowing credit growth to the private sector

Year-on-year growth in credit to the private sector stood at 6.2 percent in October.

In 2016, year-on-year growth of bank claims on the private sector (excluding investments in securities) showed a slowing trend. Year-on-year growth in credit to the private sector stood at 6.2 percent in October, down from 7 percent in September. This is in line with our expectations, as we forecast credit growth to rise slightly to 7.5 percent for the remainder of 2016 but slow to 5.5 percent in 2017. In month-on-month terms, average growth in credit was 0.4 percent year-to-October, compared with 0.8 percent in 2015 (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. H1 2016 data on non-oil private sector GDP already pointed to a notable slowdown, with 0.1 percent annual growth, compared to 3.3 percent in H1 2015.

The recent policy rate increase, coupled with further anticipated hikes in 2017 is also likely to have a negative impact as credit becomes more expensive. However, previous incidences show that interest rate pass-through effects have been minimal on demand for credit. The growth in credit is likely to be more affected by any continued consolidation in government spending and general sentiment regarding the ongoing economic reform than the increase in the reverse repo rate.

The maturity profile of credit to the private sector showed a stark contrast than what the overall growth in credit may suggest.

The maturity profile of credit to the private sector showed a stark contrast than what the overall growth in credit may suggest. Average contribution from long-term credit maturities towards overall private sector credit fell from 40 percent in 2015 to only 1.2 percent year-to-October 2016 (Figure 14). This highlights the sentimental impact of the rising uncertainty, and could eventually affect shorter maturities if there are further delays to meaningful reforms that can help the private sector grow. Meanwhile, seeing this could impact growth in overall credit, banks should benefit from wider profit margins associated with shorter maturities and higher interest rates.

Figure 14: Contribution to credit growth by maturity

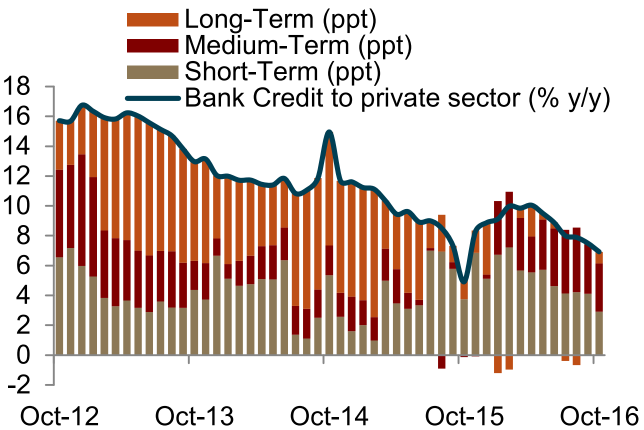
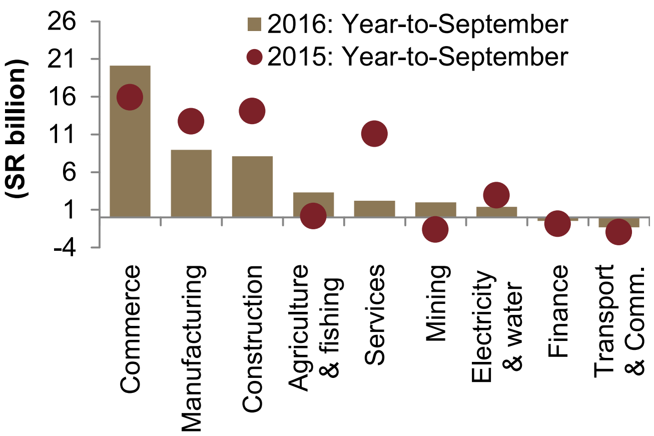


Figure 15: Credit by kind of activity



In nominal terms, net new credit rose by SR60 billion year-to-October, compared to SR98 billion during the same period in 2015. Latest quarterly corporate credit data for Q3 showed that within the private economy, net new credit was higher, year-on-year towards commerce and agriculture. Net new credit was also positive for manufacturing, construction, services, mining, and utilities, but was lower than 2015 in finance and transport (Figure 15).

Net new credit issued to the commerce sector stood at SR20 billion in Q3 2016...

...posting a healthy rise compared to the same period in 2015.

Net new credit issued to the commerce sector stood at SR20 billion in Q3 2016, posting a healthy rise compared to the same period in 2015, when net new credit reached SR16 billion. This does not seem to reflect the overall trend in non-oil economic activity but could mean that banks are repositioning their loans away from other more cyclically exposed sectors. 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.

Credit issued to manufacturing remained high in Q3, as firms seek to manage their cash flows.

Subdued prices for basic materials and higher costs for domestic energy consumption continued to impact profit margins of Saudi manufacturers. Latest Q3 2016 income data for listed petrochemicals on Tadawul came out flat, year-on-year, following a negative growth of 30 percent during the same period in 2015. This however, could be pointing to better management of costs as businesses adjusted to higher energy prices during 2016. This transition process could also explain why net credit issued to the sector remained high in Q3, as manufacturers seek to manage their cash flows. Further, credit to manufacturing constitutes 60 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, significant capacity additions and the continued expansion of the sector will likely result in positive growth in credit to the sector during 2017.

The construction sector continued to be one of the largest recipients of new credit...

...receiving SR8 billion in Q3, lower than the SR14 billion received in Q3 2015.

The construction sector continued to be one of the largest recipients of new credit, receiving SR8 billion in Q3, lower than the SR14 billion received in Q3 2015. We think that the main factor behind this rise was that credit demand increased as contractors needed liquidity to manage their cash flows while the government started deferring its capital spending. The higher credit to the sector came along with negative earnings results for construction companies listed on Tadawul, as indicated by the 80 percent year-on-year decline in the sector's income during Q3. We believe that recent payments by the

Figure 16: Loans to consumers and corporates

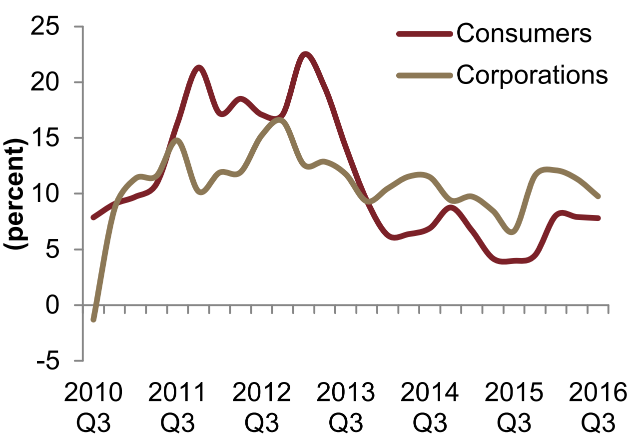
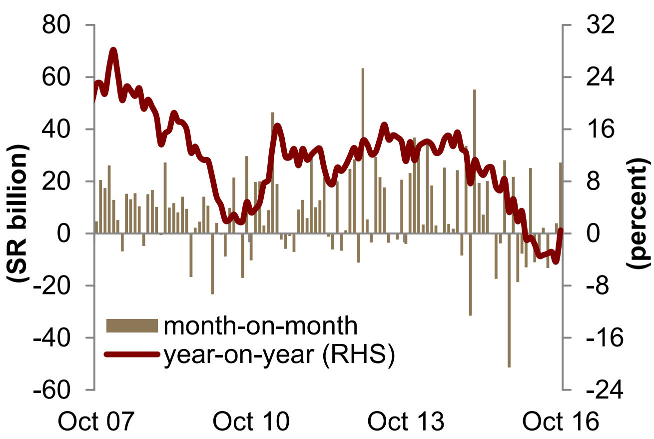


Figure 17: Growth in total bank deposits



Ministry of Finance will have a positive but limited impact on the outlook of the construction sector, and therefore expect a lower value of new credit extended by banks over coming quarters.

The electricity and water sector saw a net increase of SR1.4 billion, in new credit, slightly lower than the SR2.9 billion received during Q3 2015. 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 sector's growth prospects remain positive and are least impacted by the potential cuts in government capital spending.

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

...but showed a slight improvement relative to Q3 2015.

Net new credit issued to the finance and transport sectors was negative, but showed a slight improvement relative to Q3 2015. Nevertheless, the negative growth in credit reflects the 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 a similar trend in credit growth during 2017.

Consumer credit growth continues

Year-to-October data on consumer credit showed an improving trend over the previous year.

Year-to-October data on consumer credit showed an improving trend over the previous year. Year-on-year growth of bank credit to consumers reached 7.8 percent in October, up from 4 percent during the same period in 2015. In nominal terms, net consumer credit rose by SR16.8 billion year-to-October 2016, compared to SR5.9 billion during the same period last year (Figure 16). We view the recovery in consumer credit being due to the lower consumer exposure to the overall slowdown in the economy. Nevertheless, the October allowance reductions to public sector employees will likely have a negative impact on growth in consumer credit, particularly on consumer discretionary items, during Q4 2016 and 2017.

We expect annual growth in credit to the private sector to slow to 7.5 percent and 5.5 percent towards the end of 2016 and 2017, down from 9.8 percent growth recorded in 2015. Lower spending by the government, particularly on wages, will translate into less credit being extended to consumers. Whereas growth in corporate credit will hinge on the general sentiment within the economy and the pace of implementation of the NTP. Also, regional geopolitical risk and the external economic environment present downside risks on the general market sentiment.

Growth in bank deposits rebounds, profits stable

Year-on-year growth in total bank deposits rose to 0.5 percent in October…

...its first positive growth in nine months.

Year-on-year growth in total bank deposits rose to 0.5 percent in October, its first positive growth in nine months (Figure 17). This was mainly due to a large addition to private sector deposits (up by SR28 billion in October) as the government recommenced payments to businesses. Meanwhile, government deposits fell by SR7.6 billion, month-on-month. The rebound in deposit growth, coupled with the moderation in bank credit growth resulted in a decline in the loan-to-deposit ratio; falling below 90 percent for the first time in five months. The regulatory 90 percent loan-to-deposit ratio -which includes long-term debt from banks' balance sheets in the denominator- reached 84.2 percent in September, and is expected to have fallen further in October, comfortably lower than the regulatory limit of 90 percent set by SAMA earlier in the year.

We expect the performance of banks to continue at a weakening pace.

The surge in net capital outflows in Q4 2015 and Q1 2016 has moderated in Q2 and Q3 2016…

...mainly owing to improving current account deficits and a surplus in the non-reserve financial account.

In Q4, we expect a further moderation in net capital outflows.

In October, banks posted negative year-on-year growth in profits for the second time in 2016. Growth in bank profits was down by 0.1 percent, and was likely due to a recent uptick in bank provisions. During Q3, provisions rose to a four year high as banks took precautionary measures in anticipation of any increase in non-performing loans. However, liquidity conditions remained stable in Q3 as the coverage ratio declined only slightly, while the ratio of non-performing loans to total credit was nearly unchanged at 1.1 percent.

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 2017. Nevertheless, we expect banks to benefit from higher interest rates on loans, while simultaneously being able to reduce overall risks through more diversified loan portfolios. Banks' 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 2017.

Net Capital outflows to moderate in 2017

The surge in net capital outflows that pushed down FX reserves in Q4 2015 and Q1 2016 has moderated in Q2 and Q3 2016. This was mainly due to improving current account deficits and a surplus in the non-reserve financial account (Figure 18). While the current account improved as a result of recovering oil exports, the surplus in the non-reserve financial account was mainly due to banks and independent organizations selling foreign assets to channel proceeds back into the Kingdom (Figure 19). This inward channeling of financial assets was likely done in order to purchase government bonds that were issued throughout that same period. In Q4, we expect a further moderation in net capital outflows, mainly as a result of the $17.5 billion sovereign bond issuance in October. The bond receipts should improve the non-reserve financial account balance, thereby reducing any additional financing requirements from FX reserves. Previous surges in capital outflows were consistent with periods of financial uncertainty (1998 Asian financial crisis, and the 2008 global financial crisis). However, this time, the earlier surge in outflows seems to combine global factors of financial volatility, with rising domestic economic challenges, and geopolitical uncertainty. That said, the implementation of structural reform, as stipulated in NTP 2020 and Vision 2030, should become even the more necessary; leading to a reduction in the extent of capital outflows and negative sentiment.

Figure 18: Capital flows and FX reserve assets

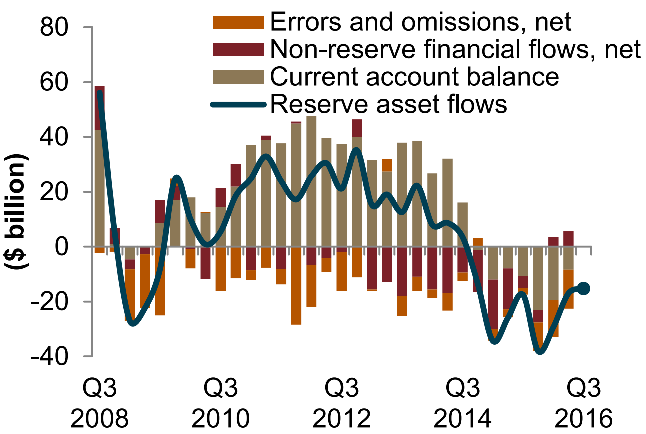
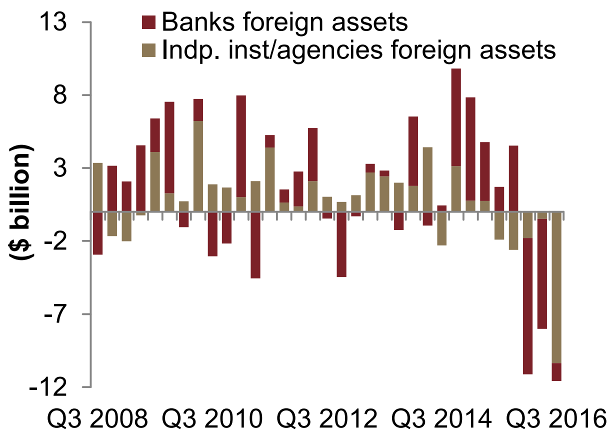


Figure 19: Banks and independent agencies foreign assets (quarter-on-quarter net change)



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