جدوى للإستثمار
Jadwa Investment

December 2017

Monetary and Financial Update

Rebound in Monetary Aggregates

Key Indicators
Percent, year-on-year

Indicator	Oct 2016	Oct 2017
M3	0.4	-0.6
Credit to private sector	6.2	-1.5
Claims on public sector	105.3	28.6
Total deposits	0.5	-0.5
Loan-to-deposit ratio	0.9	0.9

- **Monetary Policy - Global:** The US Federal Reserve (Fed) is widely expected to raise the Federal Fund Rate (FFR) by 25 basis points (bps) in the coming week, which would be the third such rise during 2017, resulting in the FFR rising to 1.50 percent.

- **Monetary Policy - Domestic:** SAMA has been following the US Fed in raising its reverse repo rate, in line with the FFR, but has so far kept the repo rate unchanged at 2 percent. Looking ahead, as further Fed tightening takes place, we do anticipate a gradual increase in the repo rate, to 2.5 percent, by the end of 2018.

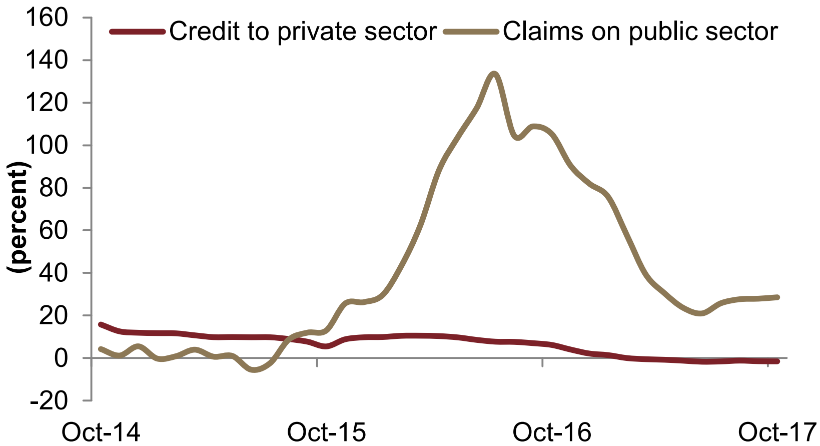
- **Liquidity:** In recent months, liquidity pressures and interbank interest rates have eased, with 3-month SAIBOR falling to 1.8 percent in October 2017 vs. 2.3 percent in October 2016.

- **Money Supply and Private Spending:** Latest M3 data shows a marginal decline by 0.6 percent year-on-year in October, for the first time in 2017. However, data shows growth in point of sales transactions and ATM cash withdrawals.

- **Claims on the Public Sector:** A number of domestic sukuk issuances during the past few months have resulted in pushing up bank claims on the public sector to 17.1 percent of total claims by end of October 2017, compared to 13.6 percent during the same period last year.

- **Credit to the Private Sector:** Although year-on-year growth in credit to private sector declined by 1.5 percent in October 2017, on a year-to-date basis, there has been a notable increase of 1 percent.

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



For comments and queries please contact:

Fahad Alturki
Chief Economist & Head of Research
falturki@jadwa.com

Head office:

Phone +966 11 279-1111
Fax +966 11 279-1571
P.O. Box 60677, Riyadh 11555
Kingdom of Saudi Arabia
www.jadwa.com

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Global Monetary Outlook

A third rise is highly anticipated in the Fed's meeting in the coming week, where the FFR is expected to reach 1.5 percent.

So far in 2017, the Fed has raised the FFR twice, the first in April, and the second in June, by 25 bps on each occasion. A third rise is highly anticipated in the Fed's meeting in the coming week, where the FFR is expected to reach 1.50 percent. Latest survey data shows that the market expects a near certain hike of 25 bps in mid-December, and three more hikes in 2018 by 25 bps each (Figure 2). Looking ahead, there are two major developments clouding the pace of interest rate rises in the near to medium term. One is the continued tightening of the US labor market, with unemployment at a 16 year low, and the other is rising inflationary pressures, with inflation currently hitting the Fed's target of 2 percent. Both of these factors are raising expectations of a steeper trajectory of rate rises. Meanwhile, there are concerns about the staggered progress of US tax reform legislation, the success of which has implications on future inflation rates and, in turn, the pace of Fed interest rate tightening. As a result, the outlook on future US interest rates is significantly affected by internal US political developments related to US tax legislation.

US interest rate tightening continues to present challenges for emerging market (EM) economies, with further financial volatility a key risk.

US interest rate tightening continues to present challenges for emerging market (EM) economies, with further financial volatility a key risk. EM economies, especially those that hold large dollar-denominated debt, are likely to be more vulnerable to large and volatile capital outflows, something which has been observed with Fed hikes in late 2015 and late 2016 (Figure 3).

The ECB chose to reduce the size of monetary stimulus for another nine months, until September 2018.

Meanwhile, inflation in the European Union (EU) stood at 0.9 percent year-to-October, substantially below the medium-term target of 2 percent. Following a meeting in October 2017 the European Central Bank's (ECB) choose to reduce the size of monetary stimulus for another nine months, until September 2018. If monetary stimulus does cease after September 2018, the main challenge for the ECB will be to ensure an 'orderly exit' to the stimulus program, and avoid disruptions akin to the 'Taper Tantrum' seen in the US in 2013, which pushed up US treasury yields after investor panic set in.

Japan continues to see weak inflationary trends, with prices up 0.5 percent year-to-October, far below the Bank of Japan's (BoJ) target of 2 percent. Whilst deflation might be seen as a risk in Japan's economy, the BoJ is not likely to change its interest rate policy in the near future.

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

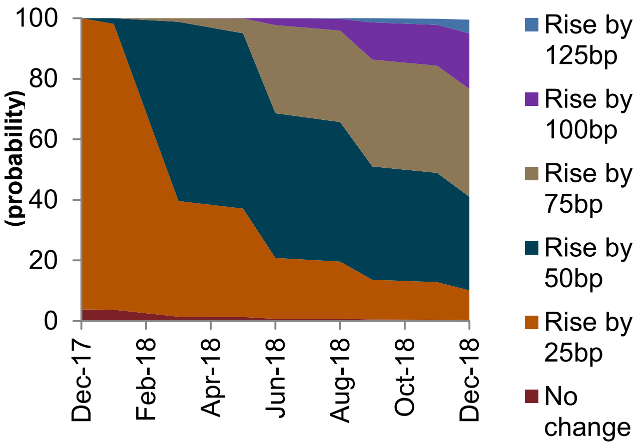
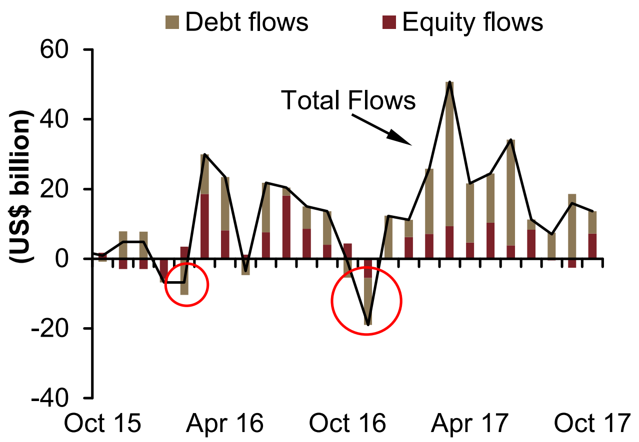


Figure 3: Emerging markets portfolio flows



Saudi Monetary and Financial Outlook

A rise in interest rates in June by the US Fed saw SAMA mirroring this rise by increasing its reverse repo policy rate by 25 basis points to 1.25 percent.

In June 2017, a rise in interest rates by the US Fed saw the Saudi Arabian Monetary Authority (SAMA) mirroring this rise by increasing its reverse repo policy rate (RRR) by 25 basis points (bps) to 1.25 percent. SAMA's key policy repo rate, however, was unchanged at 2 percent, resulting in a break in an 8-year old 100 bps spread between the RRR and repo rate in Saudi Arabia (Figure 4). We see this as part of SAMA's continuous measures to ensure suitable levels of liquidity in the domestic financial system, especially so in the context of slower economic growth and rising funding costs for various reasons.

As the Fed continues to tighten interest rates in 2018, and as the gap between SAMA's repo and reverse repo rate shrinks, we expect to see a rise in the repo rate, to 2.5 percent by the end of 2018.

The Governor of SAMA recently indicated that a number of tools could be used to manage liquidity in the local market. These could include deposit placements and swap arrangements, both of which have been used in the Kingdom previously, with serious consideration also being paid to the use of open market operations. Despite this, as the Fed continues to tighten interest rates in the year ahead, and as the gap between SAMA's repo and reverse repo rate shrinks, we expect to see a rise in the repo rate, to 2.5 percent, by the end of 2018.

A number of domestic sukuk issuances during the past few months have resulted in pushing up bank claims on the public sector to 17.1 percent of total claims by October 2017, compared to 13.6 percent during the same period last year. Bank claims on the private sector, which represent 83 percent of total bank claims (including credit and other investments), increased marginally by 1 percent year-to-October, with negative growth observed for eight consecutive months until October.

<u>Money supply declined for the first time in 2017:</u>

M3 declined marginally by 0.6 percent year-on-year in October, for the first time in 2017.

In October, the broad measure of money supply (M3) reversed its positive growth trend seen since the beginning of the year, to decline marginally by 0.6 percent year-on-year in October, for the first time in 2017. This sudden drop dragged down M3 year-to-October growth to -0.1 percent, compared to -1.4 percent during the same period last year (Figure 5).

The improvements seen in monetary aggregates in 2017, compared to 2016, have been impacted by a number of factors. This

Figure 4: Market rates in Saudi Arabia

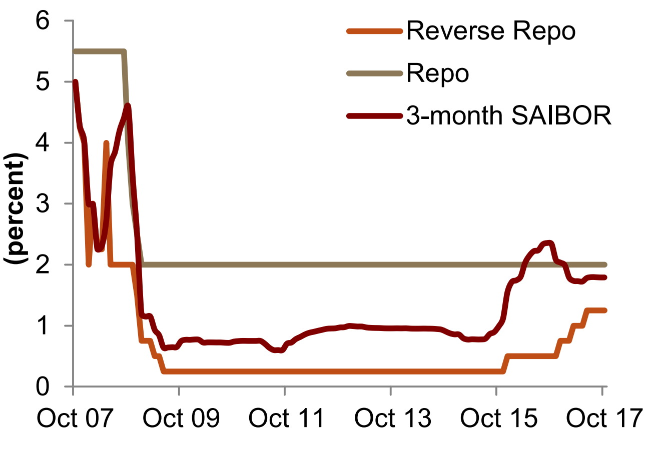
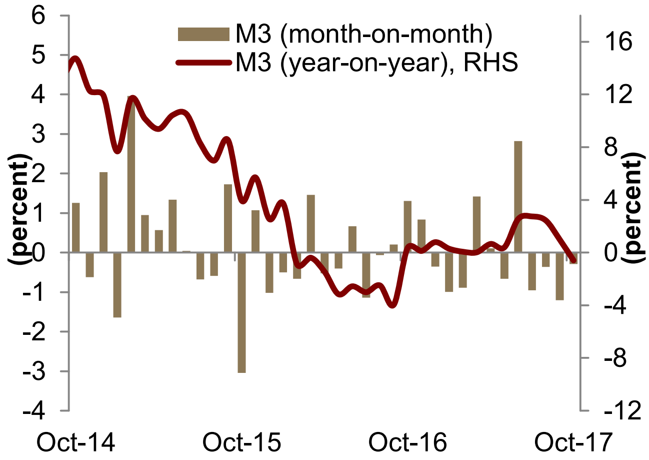


Figure 5: Growth in money supply (M3)



The recent lowering trend in time and saving deposits within the banking system might have resulted the marginal drop in money supply growth.

includes higher government spending, which, according to the latest [quarterly budget statement](#) released by the Ministry of Finance, increased by 5 percent year-on-year in Q3 2017. Further, a reinstatement of public sector allowances also took place in Q2 2017 following a royal decree. Also, international sovereign bond and sukuk issuances, totaling SR81 billion throughout the year, have also helped. This improvement has been also reflected in point of sales transactions which showed a significant rise by 4.4 percent year-to-October (Figure 6).

However, the recent decline in M3, by 0.6 percent year-on-year in October, might be caused by the recent lowering trend in time and saving deposits within the banking system (see below).

A rise in liquidity, with a shrink in savings:

Total bank deposits saw flat performance year-to-October. Looking into the breakdown in deposits in October 2017, we can see that the recent lowering trend in time and saving deposits might have resulted the recent marginal drop in money supply growth by 0.1 year-to-October. While time and saving deposits declined by 6 percent year-to-October, this drop was not met by a significant increase in demand deposits as it grew by only 1.5 percent year-to-October. This lowering trend in time and savings deposits resulted in a decline in the (M2) money supply aggregate, which contains only cash and time and saving deposits. As a result, the decline in M2 has negatively affected the growth in the broader money supply measure, M3 (Figure 7).

In recent months, liquidity pressures and interbank interest rates have eased, with 3-month SAIBOR falling to 1.8 percent in October 2017 vs. 2.3 percent in October 2016.

In recent months**,** liquidity pressures and interbank interest rates have eased, with 3-month SAIBOR falling to 1.8 percent in October 2017 vs. 2.3 percent in October 2016. As mentioned above, we see this coming from a number of factors: the government maintaining elevated levels of spending during 2017, the external sovereign bond issuances, the reinstating of public sector employees' allowances in Q2 2017, and SAMA's liquidity policy management (Figure 8).

The loan-to-deposit ratio has seen a continuous rise since the beginning of 2017, but stood at 82.5 in October, well below SAMA's regulatory limit of 90 percent (Figure 9) (see below). Looking ahead, with higher government spending expected in Q4,*(as outlined in our [Q3 Budget Statement](#) report published November 2017*) and a subsequent pick-up in non-oil private sector activity as a result, this together should support adequate growth in bank deposits in the

Figure 6: Point of sales transactions and ATM cash withdrawals, (year-on-year change)

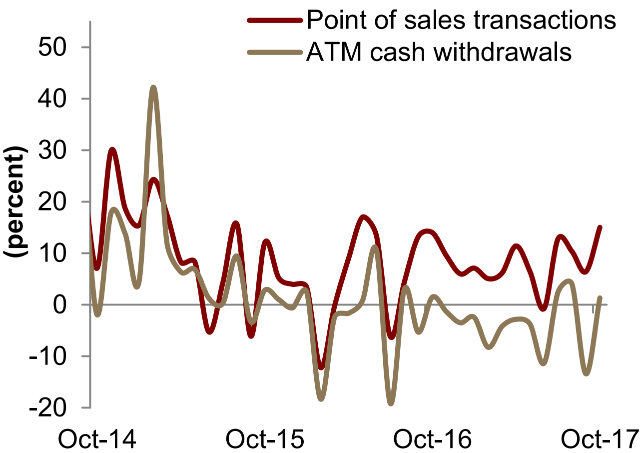
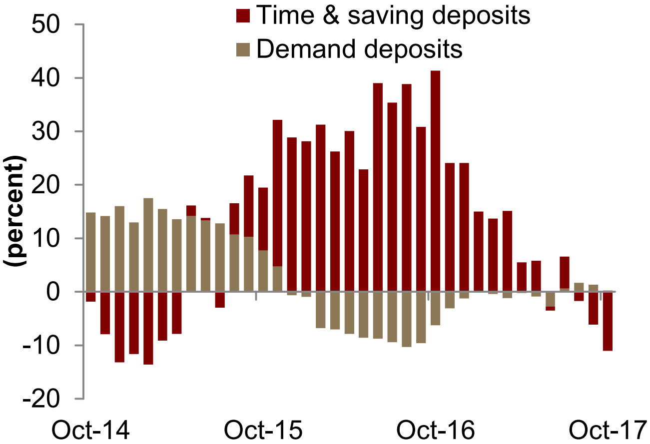


Figure 7: Breakdown of private sector deposits (year-on-year change)



Bank credit to the private sector increase by 1 percent year-to-October.

remainder of the year. In addition, the narrowing fiscal deficit seen in Q3 2017, declining by 9.3 percent year-on-year, is expected to lower the pressure on deficit financing through local banks, leaving more room for liquidity and credit to the private sector. The rebounding trend in bank credit is expected to push the loan-to-deposit ratio higher in 2018.

Bank credit to the private sector is still weak, but likely to rise:

Although year-on-year growth in credit to private sector declined by 1.5 percent in October 2017, on a year-to-date basis, there has been a notable increase of 1 percent (Figures 10 and 11).

Long-term credit has seen higher levels of growth, with an increase by 1.3 percent year-to-October, in a sign of improving domestic economic sentiment.

Long-term credit has seen higher levels of growth, with an increase by 1.3 percent year-to-October (Figure 12). We see this as a sign of improving domestic economic sentiment, with this type of credit usually indicating long-term economic confidence and generally related to more business-oriented and investment loans. Moreover, year-to-date growth in long-term credit has been the main factor preventing more steeper declines in total credit during 2017, with the share of long-term credit rising to 32 percent of total credit in October 2017, compared to 30 percent a year ago.

Sectorial performance:

Net new credit was higher, year-on-year for commerce, transportation and utilities companies.

Latest available corporate credit data shows that net new credit rose by SR12 billion year-to-September, compared to SR55 billion rise during the same period in 2016. Corporate credit data for Q3 showed that within the private sector, net new credit was higher, year-on-year, for commerce, transportation and utilities companies. Net new credit was also positive for services and finance companies, but was lower for mining and manufacturing companies (Figure 13).

Net new credit issued to construction companies did not see any significant changes in year-to-September 2017.

Net new credit issued to companies in the commerce sector grew by 20 percent year-to-September, reflecting the subdued growth in wholesale and retail's GDP by 0.1 year-on-year in H1 2017. Meanwhile, net new credit issued to construction companies did not see any significant changes year-to-September 2017. The slowdown in the construction sector has also been reflected in a number of other indicators. Construction sector's GDP declined by 2.4 percent year-on-year in H1 2017. In addition, letters of credit issued for building materials imports dropped by 11 percent year-to-October in 2017, compared to the same period last year (Figure 14).

Figure 8: Estimate of excess liquidity in banking sector

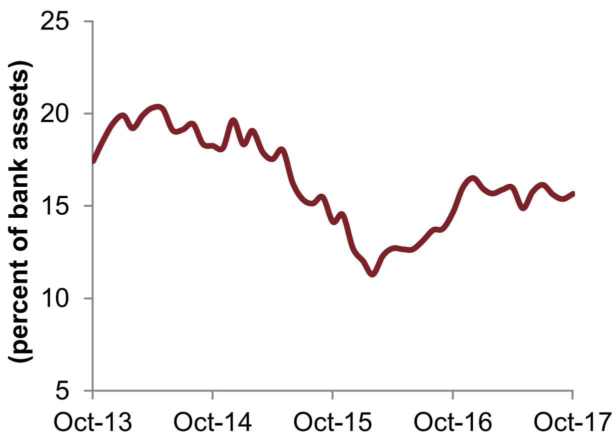


Figure 9: Loan to deposit ratio

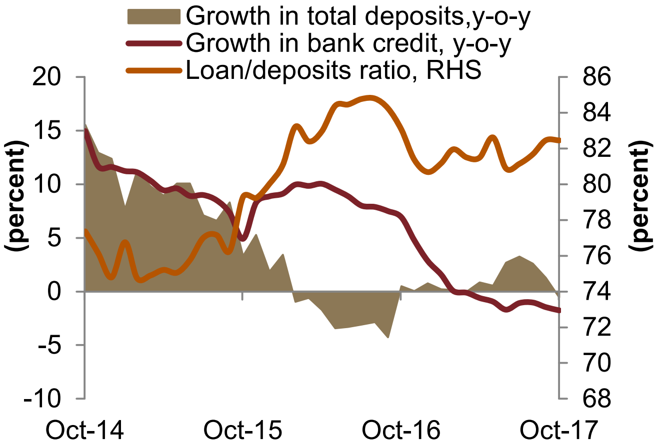


Figure 10: Growth of bank claims on the public sector, (year-on-year change)

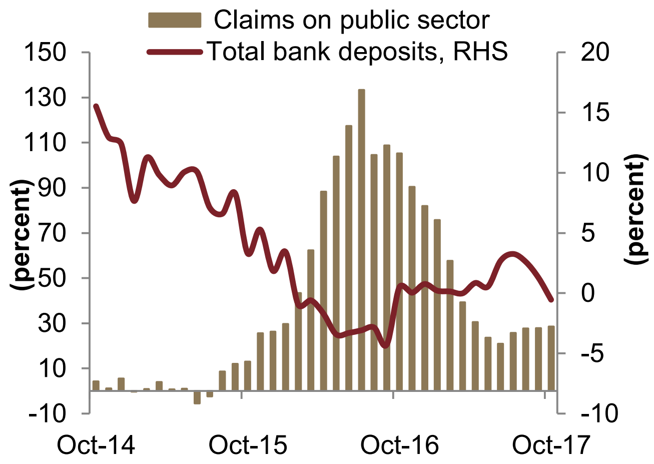


Figure 11: Growth of bank credit to the private sector, (year-on-year change)

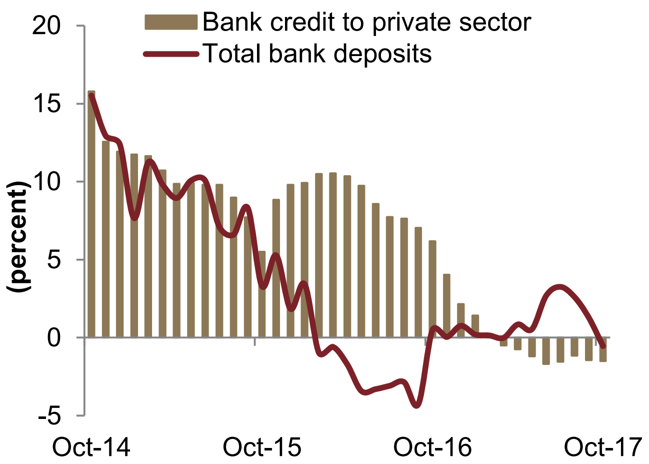


Figure 12: Credit by maturity, (year-on-year change)

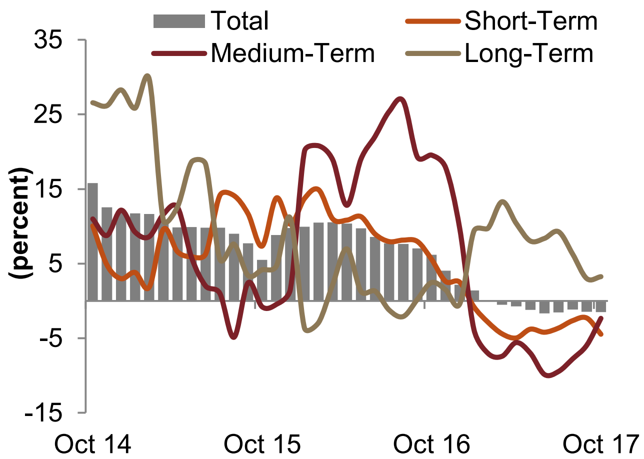


Figure 13: Change in credit to the private sector (year-to-September)

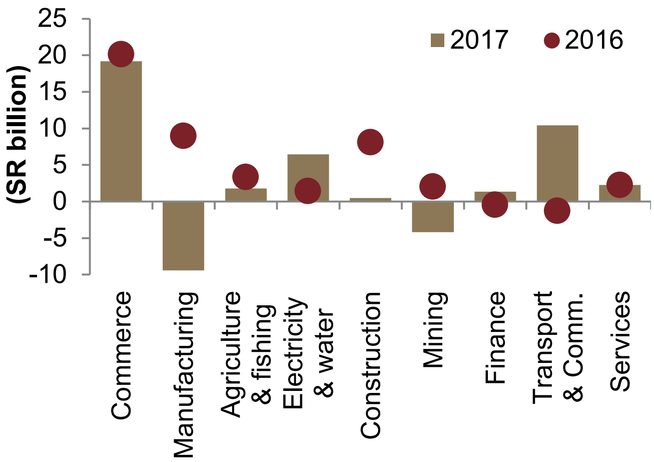


Figure 14: Change in letters of credit issued by banks, (year-to-October)

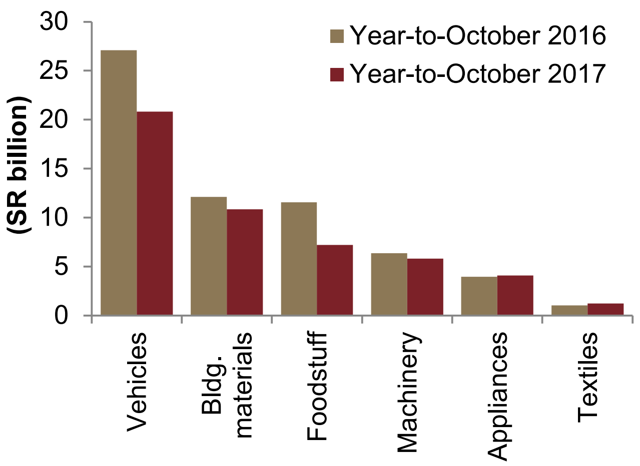
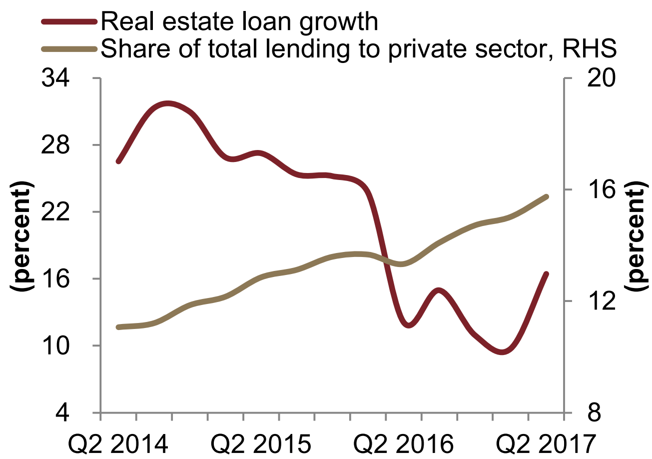


Figure 15: Real estate loan growth (year-on-year change)



Sources: General Authority for Statistics, Saudi Arabian Monetary Agency, Jadwa Investment.

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