جدوى للإستثمار
Jadwa Investment

October 2018

Monetary and Financial Update

A slow recovery in private sector lending

- **Monetary Policy - Global:** The US Federal Reserve (Fed) raised the Federal Fund Rate (FFR) in September, and is highly expected to raise it one more time this year, lifting the probability from three to four hikes in 2018, in addition to at least two more hikes expected in H1 2019.

- **Monetary Policy - Domestic:** The Saudi Arabian Monetary Authority (SAMA) is expected to introduce one additional rate rise this year, and two more next year, following the Fed's rate decisions.

- **Money Supply:** Year-to-August, M3 was marginally up by 0.2 percent. Out of all the money supply aggregates, (M1, M2, M3), M1 showed the highest rise year-to-August, boosted by a rise in currency in circulation, which was up by 7.2 percent

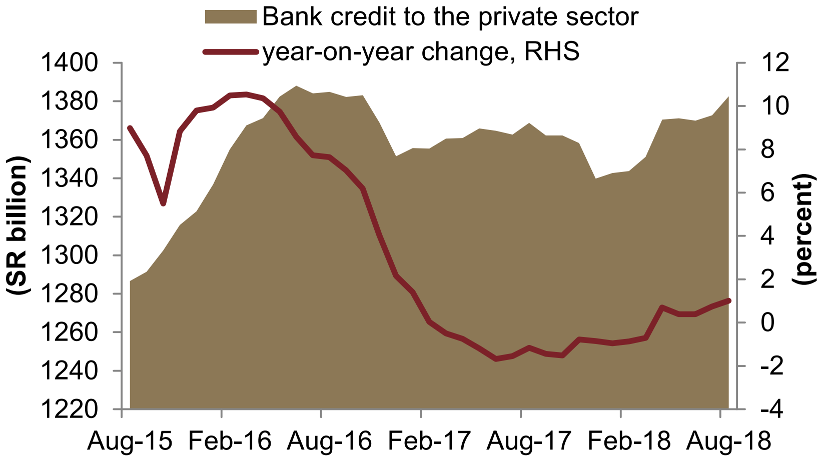
- **Claims on the Public Sector:** Lifted by government bonds, bank claims on the public sector rose by 12.2 percent year-to-August. However, the rise came lower than its pace in 2017 when it increased by 22.1 percent for the same period.

- **Claims on the Private Sector:** Year-to-August, total bank claims on the private sector rose by 3.4 percent, supported by an increase in credit to the private sector, which was up 3.2 percent year-to-August, compared to 1.3 percent for the same period last year.

- **Mortgage Lending:** A number of measures have been introduced to boost home ownership through home financing, which resulted in mortgage lending growing by 5.8 percent year-to-June, compared to 4 percent for the same time last year.

- **Sectorial Performance:** New corporate credit was higher for construction, mining, transportation and manufacturing, but was lower for commerce and utilities, year-to-June.

Figure 1: Bank Credit to the Private Sector
(year-on-year change)



Key Indicators
Percent, year-to-August

Indicator	Year-to-August 2017	Year-to-August 2018
M3	0.4	0.2
Credit to private sector	1.3	3.2
Claims on public sector	22.1	12.2
Private deposits	-2.3	2.0
Loan-to-deposit ratio*	81.6	79.3

**Period average*

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Global Monetary Outlook

The Fed is expected to have one more interest rate rise during this year, and two more in H1 2019.

Since the beginning of 2018, the Fed has raised the FFR three times, the first in March, and the second in June, and the third in September, by 25 bps on each occasion. As the FFR reached a range between 2 percent to 2.25 percent, it marks the eighth rate increase since December 2015. Latest survey data shows that the market expects one more hike this year in December, raising the probability from three to four hikes in 2018 (Figure 2).

Employment continued to grow strongly in the US labor market in recent months, and inflation is rising.

Looking ahead, we see a high probability of a moderate acceleration to the pace of rate hikes, with at least two more FFR hikes in H1 2019, depending on a number of factors. First, employment continues to grow strongly in the US, second, inflationary pressures is rising, triggered by higher wages and consumer spending, which has resulted in inflation hitting the Fed's 2 percent target many times this year. However, we see trade tensions between the US and China as a developing element that could affect US monetary policy in 2019, depending on the ongoing negotiations between the two countries.

The ECB is expected to hold interest rates unchanged this year.

Within the European Union (EU), the European Central Bank (ECB) is expected to hold interest rates unchanged this year, as its program of quantitative easing is expected to end this December. Aside from Spain and Italy, unemployment rates in the EU are declining to reach levels prior to the financial crisis. Moreover, inflation has seen significant rises in the EU recently, with the average rate rising to 2.1 percent. However, the ECB hinted that the main risks to activity are trade protectionism and Brexit, and therefore slightly lowered its forecast of Euro area growth to 2 percent in 2018 and 1.8 percent in 2019.

The BoE has indicated that further hikes will be needed to curb the inflationary pressures.

In the UK, Brexit remains the big question mark. With deadline approaching in March 2019, the government needs to finalize a deal with the EU over trade, amongst other things. However, latest data from the Bank of England (BoE) shows that the economy has grown at a faster pace than anticipated, which justified the BoE's decision to raise interest rates back in August. That said, the BoE has indicated that further hikes will be needed to curb expected inflationary pressures.

Emerging markets have seen inflation rates rising in recent months, affected by the hikes in Argentina and Turkey, with both countries going through currency crises (Box 1), and their currencies having

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

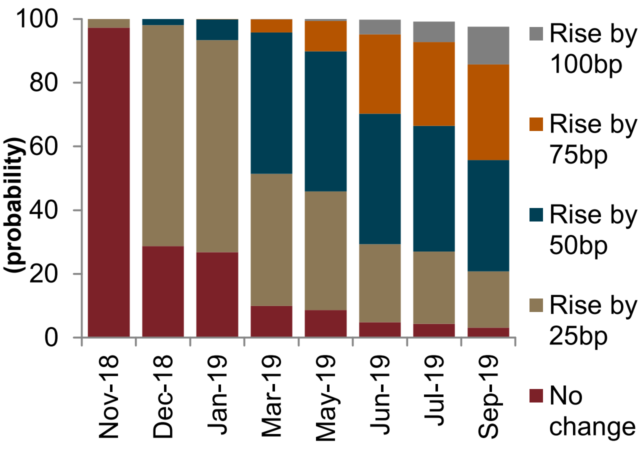
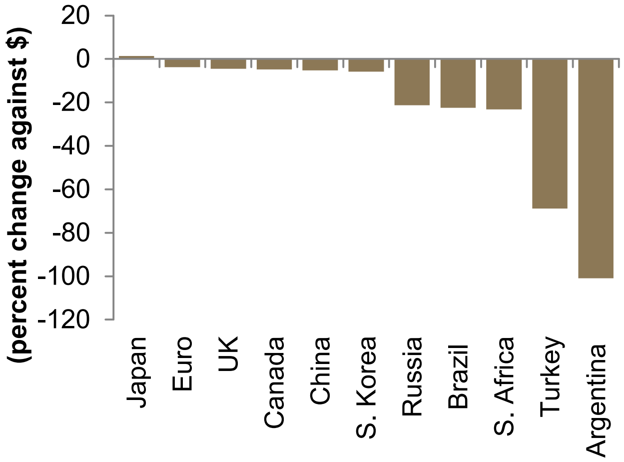


Figure 3: Exchange Rates in Selected Countries
(year-to-date)



fallen by the most this year (Figure 3). Meanwhile, China is trying to control the impact of US tariffs on an additional $200 billion worth of Chinese goods, which will result in further pressuring the Yuan.

Box 1: Emerging markets monetary stress

EM debt has grown rapidly since 2010.

As we highlighted in our [Saudi Economy in 2018](#) report, EM debt has grown rapidly since 2010. The concern we highlighted was that whilst the rate of EM GDP growth had moderated since 2010, from 7.4 percent in 2010 to an expected 4.9 percent in 2018, total external debt had not. Total external debt of EM countries rose to over $40 trillion since the 2008-2009 global financial crisis, and the combined debt of 26 large EM rose from 148 percent of GDP at the end of 2008 to 211 percent by the end of 2017.

Whilst the rate of EM GDP growth had moderated since 2010, total external debt had not.

Since the beginning of 2018, risks to EM were correlated with the ongoing rounds of US tariffs on Chinese imports, which would weigh on the Chinese Yuan and escalate the trade tension. Recently, the US administration put an additional $200 billion worth of Chinese goods subject to a 10 percent tariff starting September 24. This further inclusion is expected to weigh on trade negotiations between the two nations, and on the valuation of the Chinese Yuan.

Both Argentinian Peso and Turkish Lira have fallen sharply in real effective terms.

In other emerging economies, both the Argentinian Peso and the Turkish Lira have fallen sharply in real effective terms, which resulted in both currencies to be undervalued. In Argentina, the central bank has hiked interest rates to 60 percent, and the government announced severe budget cuts for 2019. Looking forward, markets are watching for the size of the IMF package requested by the government, and if it is going to be large enough to lift the economy and remove external funding concerns in the short term.

Despite the taken measures, the Turkish economy is seen to be affected by the US sanctions.

Meanwhile in Turkey, as the Lira was faced with sell-off and undervaluation, monetary policy makers had initially declined to raise its main policy rate, and instead, announced a number of technical measures. Eventually, faced with inflation rising up to 19 percent in recent figures, the central bank raised its interest rates to 24 percent in a recent meeting in September. Despite these measures, the Turkish economy is seen to be affected by the US sanctions after political tensions in August. Looking forward, investors are cautiously waiting for the government to apply its three-year economic plan announced on September 20th.

In the short term, markets are more concerned about extending the trade tensions between China and the US.

In the short term, despite the currency turmoil in Argentina and Turkey, markets are more concerned about the trade tensions between China and the US, which would cause a further devaluation in the Yuan and therefore result in a spill-over effect in other EM.

Figure 4: Market Rates in Saudi Arabia

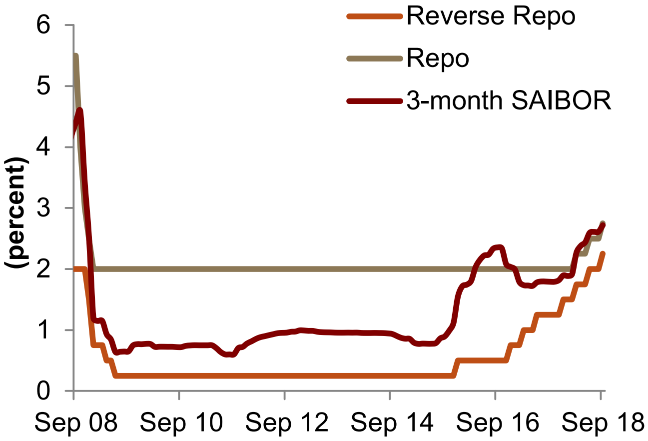
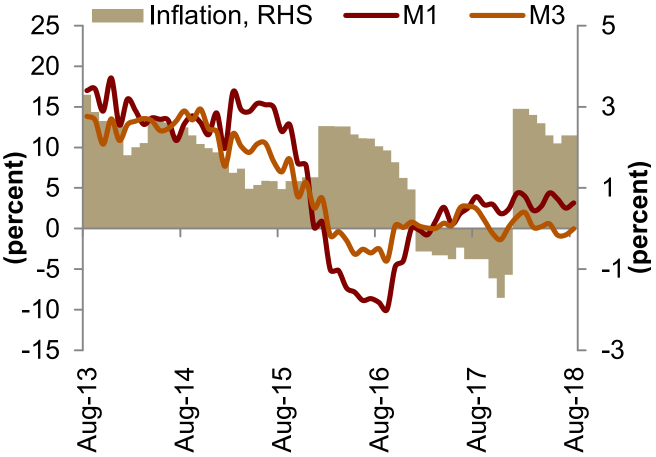


Figure 5: Money Supply
(year-on-year change)



Saudi Monetary and Financial Outlook

SAMA has increased the reverse repo and repo rates by 25 bps three times this year.

Since the beginning of the year, the Saudi Arabian Monetary Authority (SAMA) has increased the reverse repo and repo rates by 25 basis points (bps) three times, in March, June and September 2018 (Figure 4). The rises came in-line with the US Fed's interest rates hikes. Accordingly, we expect to see one additional rise this year, and two more next year, following the Fed's rate decisions. In addition, the 3-month SAIBOR/US-LIBOR spread has recently widened, after narrowing for several months in the beginning of the year.

Money supply, liquidity and deposits

Year-to-August, M3 was marginally up by 0.2 percent.

Year-to-August, the broad measure of money supply (M3) was marginally up by 0.2 percent. Out of all the money supply aggregates, (M1, M2, M3), M1 showed the highest rise year-to-August, boosted by a rise in currency in circulation, which rose by 7.2 percent (Figure 5). Bank deposits, one of M3's components, was probably affected by the maturity of government deposits.

As liquidity mounted in the first few months of 2018, SAMA indicated, in April, that it would allow some government deposits placed with commercial banks to mature, and place them back to the central bank instead. This resulted in the amounts of government deposits with commercial banks declining by 8 percent year-to-August. Excess liquidity in the banking system was marginally down during Q2, which, in turn, led to a pickup in SAIBOR during the same quarter, and took the loan-to-deposit ratio upwards (Figure 6). However, recent data shows that credit to the private sector improved in July and August, which has likely resulted in an increase in loan-to-deposit ratio, up to 79.7 percent in August, well below SAMA's regulatory limit of 90 percent.

Government deposits declined by 8 percent, year-to-August, after growing as much as 12.6 percent over the same period last year, which is likely to have had some impact on money supply aggregates. The decline in government deposits is also reflected in the increasing amount of government current spending, which saw a rise by 28 percent year-on-year during H1 2018. In a recent note, the IMF reported that the government is transferring around SR50 billion (equivalent to 1.7 percent of GDP) from its deposits at SAMA to specialized credit institutions for on lending. As part of the Fiscal

Figure 6: Excess Liquidity in the Banking System

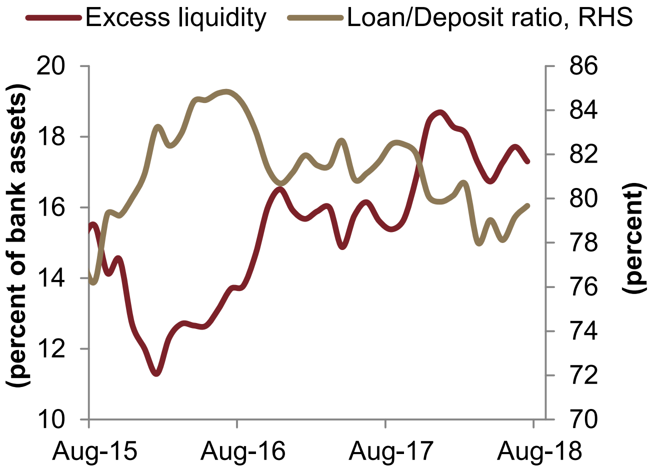
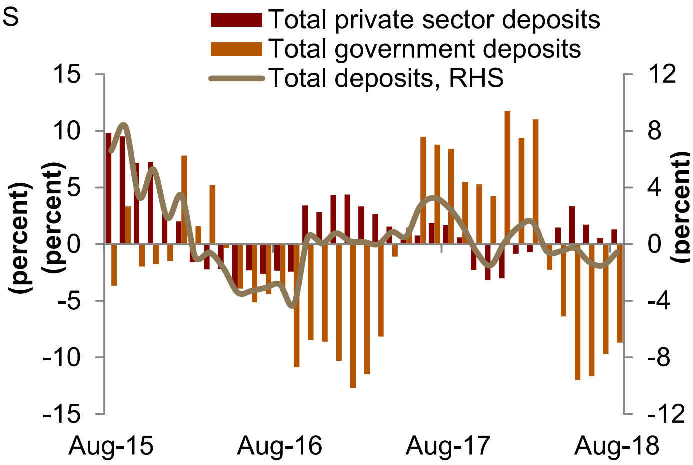


Figure 7: Bank Deposits: Private vs. Government (year-on-year change)



The SIDF saw a rise by 37 percent in its funding to the private sector, with a total of SR4.3 billion.

Private sector deposits rose by 2 percent year-to-August, compared to a decline by 2.3 percent for the same period last year.

Total time deposits have been going through a downward trend since October 2017, and declining by 5 percent year-to-August…

...mainly affected by declining government time deposits.

Budget of 2018, the government announced a plan to spend a total of SR133 billion outside the budget in 2018, with SR50 billion to be spent by the National Development Fund (NDF) and SR83 billion by the Public Investment Fund (PIF), to be used for financing private sector projects.

One of the NDF's dominant funds, the Saudi Industrial Development Fund (SIDF), has recently announced a rise by 37 percent year-on-year in its funding to the private sector in H1 2018, with a total credit of SR4.3 billion. The SIDF accounts for 16 percent of total outstanding NDF loans, coming second after the Real Estate Development Fund (67 percent of total outstanding NDF loans).

At the same time, private sector deposits rose year-to-August, growing by 2 percent, compared to a decline by 2.3 percent for the same period last year. Private sector deposits account for 78 percent of total deposits, and have the dominant effect on its movements (Figure 7).

Looking at the distribution of time deposits vs. demand deposits, we find that total time deposits have followed a downward trend since October 2017, declining by 5 percent year-to-August. This trend is largely due to the declining government time deposits (43 percent of total time deposits), which dropped by 8.7 percent year-to-August. Simultaneously, private time deposits declined as well, although on a lower rate, by 2 percent year-to-August (Figure 8). Meanwhile, demand deposits rose by 1.7 percent year-to-August, supported by a rise in private demand deposits by 2.3 percent during the same period. The rise is likely to be supported by government payments under the Citizen's Account program, which commenced on 20th December 2017. As the Q2 2018 Fiscal Budget showed, 'Social Benefits', which covers the Citizen's Account, saw large rises by around 91 percent year-to-June, up to SR25 billion.

Nonetheless, the decline in time deposits comes in contrast with the rising interest rates, which would theoretically attract more time deposits. However, as we discussed above, a big share of total government deposits are expected to have been transferred to the NDF for on lending, which would reflect on the total amount of time deposits.

Figure 8: Breakdown of Government Deposits
(year-on-year change)

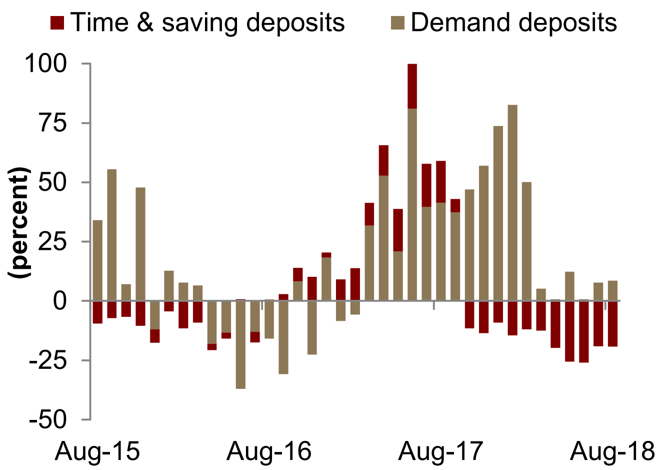
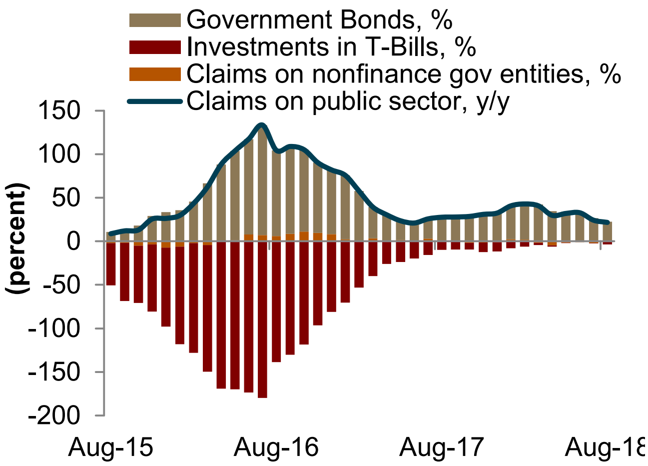


Figure 9: Bank Claims on the Public Sector
(Contribution)



Total bank claims rose by 5 percent year-to-August, supported by a rise in claims to the public sector…

...which rose by 12.2 percent year-to-August.

At the same time, bank claims on the private sector rose by 3.4 percent year-to-August.

Long-term credit rose significantly by 9.3 percent year-to-July.

Bank claims

Total bank claims rose by 5 percent year-to-August, supported by a rise in claims to the public sector, up 12.2 percent year-to-August, equal to 19 percent of total bank claims. All types of bank claims to the public sector have seen a rise since the beginning of the year, but government bonds showed the highest rise, by 14.2 percent year -to-August (Figure 9). That said, the larger claims on the public sector were lower than the pace in 2017, when it increased by 22 percent during the same period (Figure 10).

As of September 2018, outstanding public debt reached SR551 billion (Table 1). During Q1 2018, there has been SR18 billion in domestic sukuk issuances and a SR60 billion syndicated loan refinancing, which expanded the original facility by SR22.5 billion. In Q2 2018, the government announced the issuance of a SR42 billion international bond and a further issuance of a total of SR12 billion in domestic sukuk (for more on this please see our *Quarterly Budget Report Q2 2018*). In Q3 2018, another domestic sukuk for SR3.5 billion had been issued, followed by the issuance of SR7 billion international sukuk. As of September 2018, a total of SR109 billion of debt had been issued this year and we expect debt issuances not to exceed SR117 billion in 2018, as per the fiscal budget statement. At this rate therefore, we see a further SR8 billion in domestic bond issuances during the remainder of the year, taking total debt to SR560 billion at the end of 2018, equivalent to 19 percent of GDP.

At the same time, bank claims on the private sector (81 percent of total bank claims) rose by 3.4 percent year-to-August, supported by an increase in credit to the private sector, which was up 3.2 percent year-to-August, compared to 1.3 percent for the same period last year. In fact, the annual growth in credit to the private sector has been in the positive territory for five executive months until August. Moreover, a rise in private investments in financial securities, which was up by 8.5 percent year-to-August, has also contributed to the growth in claims to the private sector.

Long-term credit rose significantly by 9.3 percent year-to-July, whilst monthly data for July showed that long term credit rose by 4.7 percent year-on-year, marking the first annual rise since November 2017. Usually, long-term credit is considered as a significant lending indicator for corporate and business lending, which could show that the private sector is witnessing a pick-up in activity in coming months (Figure 11).

Figure 10: Commercial Banks Claims
(year-on-year change)

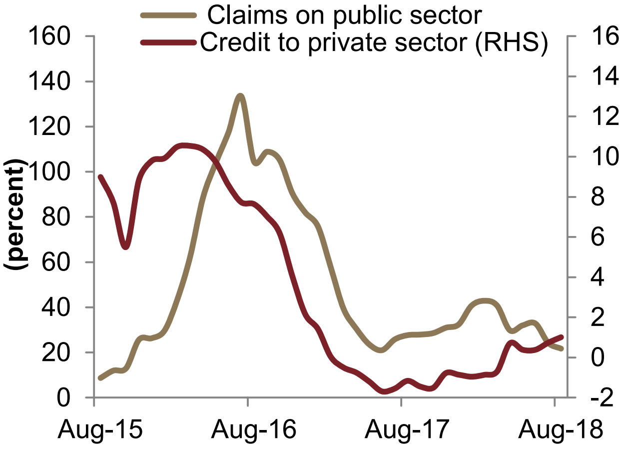
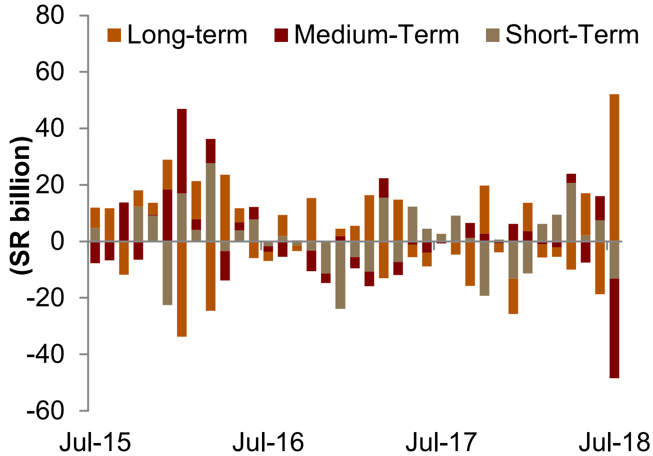


Figure 11: Bank Credit by Maturity
(month-on-month change)



Mortgage lending by commercial banks is picking up again in 2018, after slowing down in 2017.

A number of measures have been introduced to target both new and existing mortgage holders in order to boost home ownership through home financing.

Lower housing prices might have also incentivized higher demand on mortgage loans.

Mortgage lending

Mortgage lending by commercial banks is picking up in 2018, with growth rate reaching 5.8 percent year-to-June, compared to 4 percent for the same time last year (Figure 12). Added to that, the growth in mortgage loans exceeded the growth in total credit to the private sector (2.2 percent year-to-June), whilst the share of mortgage loans in total credit to the private sector increased from 14.3 percent in Q2 2016, up to 16.4 percent in 2018.

Raising the level of homeownership for citizens has been a long-standing priority within the Kingdom, but measures to tackle the comparatively lower ownership levels have accelerated in recent years. As we show in our *Financial Sector Development Program Report*, some recent measures have been introduced to target both new and existing mortgage holders in order to boost home ownership through home financing. For example, in 2017, SAMA announced that existing mortgage holders would be exempt from administrative fees for switching between floating to fixed rates mortgage rates. SAMA also tried to make it easier for first time buyers by raising the loan-to-value ratio for home financing from 70 to 85 percent ,initially, and then to 90 percent, more recently.

Aside from making adjustments to existing mortgage products, a number of developments have taken place to raise the level of home financing options available in the Kingdom. For example, back in 2016, SAMA licensed a national home finance company called Bidaya, and introduced an affordable mortgage program in conjunction with the Ministry of Finance (MoF). More recently, towards the end of 2017, the PIF launched the Saudi Real Estate Refinance Company (SRC). Part of SRC's mandate is to raise the real estate market's contribution to the economy and increase the level of home ownership among Saudis to 52 percent by the end of 2020, from the current rate of 47 percent. Finally, the Ministry of Housing's Sakani program has also distributed 151 thousand mortgage products since its inception back in February 2017.

Lastly, housing prices have been exhibiting a downward trend in recent years. Latest GaStat data show that the residential real estate price index has been declining since Q3 2015, falling by an average of 6.2 percent in 2017, and by 0.7 percent in H1 2018. Accordingly, lower housing prices may have incentivized higher demand on mortgage loans.

Table 1: Outstanding Public Debt
(SR Billion)

	As of September 2018
Domestic bonds	202
International loans	60
International bonds	154
International sukuk	41
Domestic sukuk	96
Total	**551**

Table 2: Net New Credit, by Sector
(year-to-June change)

Sector	Weight	Year-to-June
Mining & Quarrying	1.6%	44.6%
Agriculture	1.1%	21%
Construction	7.2%	11.5%
Transport	3.8%	9%
Manufacturing	12.4%	5.5%
Finance	2.7%	3.2%
Utilities	3.7%	-0.4%
Commerce	21%	-9%

Net new credit showed a significant rise in many sectors.

We expect the slowdown in credit to commerce to continue.

Credit by kind of economic activity

Latest corporate credit data shows that year-to-June new corporate credit was higher for construction (7 percent of total corporate credit), mining (2 percent), transportation (4 percent), manufacturing (12 percent), agriculture (1 percent), finance (3 percent), and other services (41 percent). Meanwhile, new corporate credit was lower for commerce (21 percent) and utilities (4 percent) (Table 2-Figure 13).

The quarterly data for Q2 provided more evidence that credit to mining and manufacturing is growing during the first half of 2018. Credit to manufacturing rose by 8 percent and credit to mining rose by 41 percent, quarter-on-quarter, in a sign of increasing activity, as the two sectors were targeted by the private sector stimulus package announced in December 2017. Moreover, credit to construction also showed a significant rise by 5 percent in Q2, quarter-on-quarter, which is likely to be supported by the new housing programs offered by the Ministry of Housing, and higher demand on housing and mortgage loans, as discussed above. Meanwhile, commerce saw a significant decline, by 9.4 percent quarter-on-quarter, reflecting a slowdown in the sector, which was also seen in the latest GDP figures for Q2 2018, where the related sector (wholesale and retail trade) was down by 5 percent quarter-on-quarter (Figure 14).

Looking forward, we see a number of elements weighing on credit to commerce in the medium term. Firstly, we expect consumer spending to be affected by the departure of expats, as the total number of foreigners in the Saudi labor market has declined by around 796 thousand since the start of 2017 up to the end of Q1 2018. Added to that, the new Saudization wave in a number of retail sectors would likely lead to more expat departures. (Please see our latest *Labor Market Update Q1 2018*, and *Macro Update Q2 2018*).

Moreover, commerce is likely to be affected by the reduction in VAT threshold starting Q1 2019, from a turnover of SR1 million in 2018, down to SR375 thousand in January 2019. This step needs registering additional 300 thousand small and medium enterprises, with many of them in the commerce sector. Therefore, we see a structural reform taking place in the commerce sector in the medium term, which is likely to weigh on its financial activities.

At the same time, we expect to see a pick up in manufacturing and mining sectors, as the latest figures for the Index for Industrial

Figure 12: Mortgage Lending
(year-on-year change)

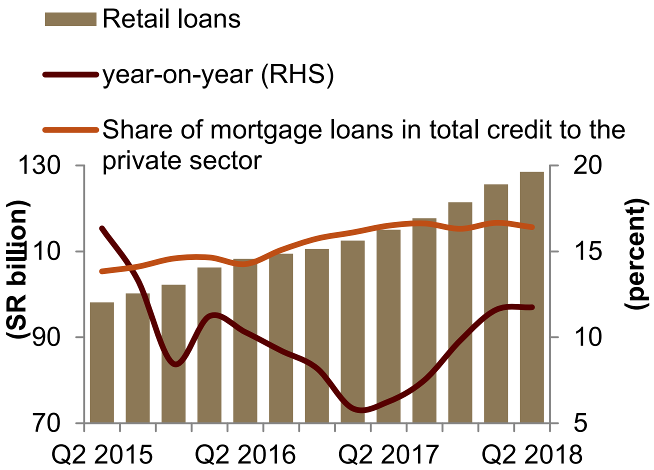
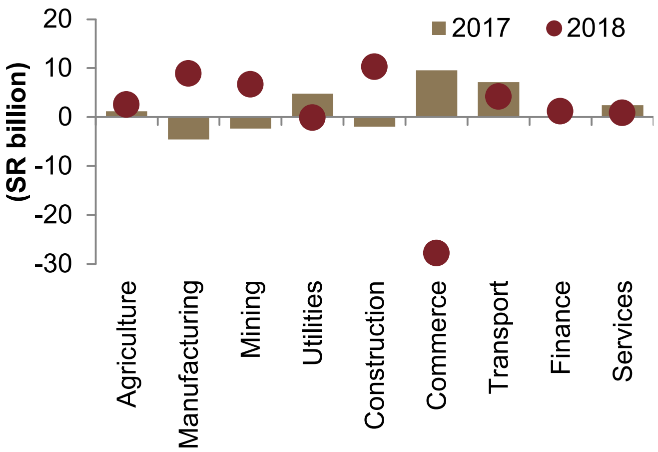


Figure 13: Net New Credit, by Sector
(year-to-June change)



At the same time, we expect to see a pick up in manufacturing and mining sectors.

Production (IIP) show an increase by 0.6 percent quarter-on-quarter, and by 3.4 percent year-on-year, during Q1 2018. The boost came mainly from an increase in mining and quarrying output, which accounts for 74 percent of the IIP index weight, rising by 2 percent year-on-year, and turning into the positive territory for the first time since Q4 2016 (Figure 15).

Figure 14: GDP Growth in Selected Sectors
(year-on-year change)

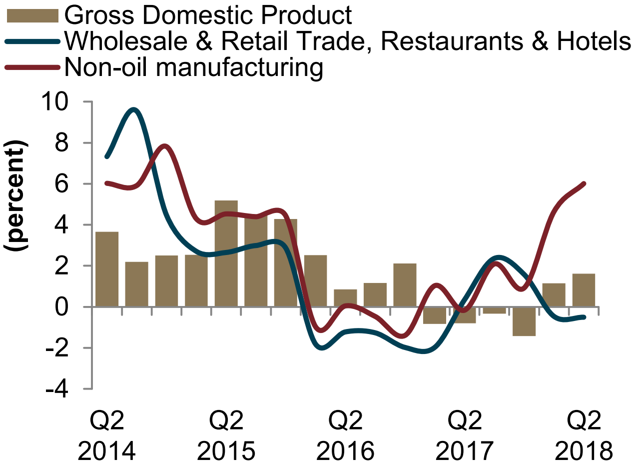
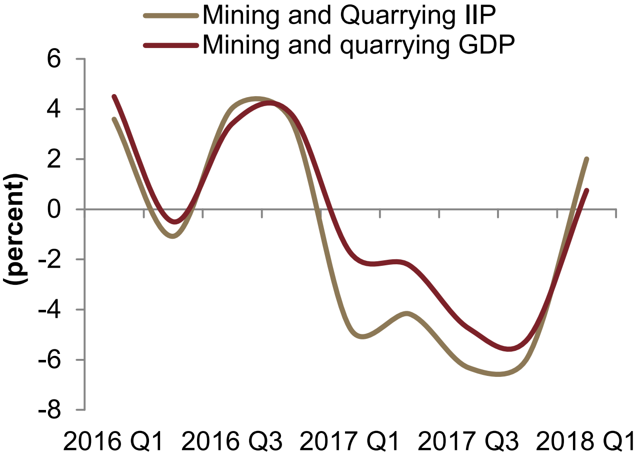


Figure 15: IIP in Mining
(year-on-year change)



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