Household and firm-level heterogeneity in monetary policy: the case of Saudi Arabia

Saudi Central Bank

Introduction

The Saudi economy is fiscally led, with its performance historically closely linked to oil market developments. These dynamics have shaped the behaviour of households and firms, reflecting the central role of fiscal policy in the economy. While traditional monetary policy transmission channels influence consumption, investment and financial conditions, their overall effectiveness remains moderated by public initiatives and fiscal expenditure. This underscores the ongoing role of government measures in supporting economic reforms and diversification efforts through Vision 2030 programmes.

Saudi Arabia's economy is undergoing a substantial transformation, with emphasis on diversification and growth in non-oil sectors. Traditionally reliant on high public sector employment and government subsidies, households are now navigating a dynamic financial landscape marked by increased access to consumer credit, home ownership programmes and policies aimed at diversifying fiscal revenues. Concurrently, government initiatives such as the Kafalah programme are being designed to support the private sector, particularly small and medium-sized enterprises (SMEs), by facilitating credit access and reducing their vulnerability to interest rate fluctuations.

The Saudi Central Bank's (SAMA's) monetary framework is anchored in the fixed exchange rate regime, which has been maintained since 1986. This regime has demonstrated resilience through periods of global and domestic economic turbulence. It has ensured monetary and financial stability and continues to play a critical role in safeguarding economic stability.

Monetary policy transmission channels

Monetary policy transmission channels, the mechanisms through which adjustments in a central bank's monetary policy impact the broader economy, serve as the critical link between monetary policy decisions and real economic outcomes for households, businesses and financial markets. It is widely recognised that the effectiveness of transmission channels varies across economies, influenced by structural factors, the development of the financial markets and the underlying monetary policy framework (Svensson (2013)).

In Saudi Arabia, monetary policy transmission channels are shaped by the characteristics of its economic and financial system. Understanding the relative strengths and limitations of these channels is vital for designing policies tailored to

Saudi Arabia's distinct economic environment. SAMA's monetary policy is centred around the fixed exchange rate regime, which requires alignment with the anchor currency's policy rate. This alignment limits flexibility for using the policy rate as a tool and means that liquidity management plays a significant role in influencing monetary conditions. As such, fiscal policy assumes a central role in steering economic activity.

Interest rate channel

The interest rate channel is widely regarded as a crucial Keynesian transmission mechanism, whereby changes in policy rates influence bank lending and deposit rates, ultimately affecting output and savings decisions (Al-Jasser (2008), Cevik and Teksoz (2013)). In Saudi Arabia, however, the effectiveness of the interest rate channel is influenced by several factors. Within the context of households, government-supported financing programmes reduce the sensitivity of borrowing costs to policy rate changes.

Conversely, private sector firms are more influenced by policy rate changes, as their borrowing costs are often tied to market rates. Empirical evidence suggests that the pass-through effect of policy rate changes in Saudi Arabia is limited (IMF (2022)). This is attributed to the role of countercyclical fiscal policy, which offsets economic fluctuations and plays a key role in supporting aggregate demand and economic activity, while the central bank's policies are designed to maintain monetary and financial stability to ensure sustainable economic growth.

Credit channel

The credit channel, the mechanism through which monetary policy influences the availability of credit within the economy, operates through two primary subchannels:

- The bank lending channel: this channel reflects how monetary policy impacts the capacity of banks to provide loans to firms and households.
- The balance sheet channel: this channel functions by influencing firms' borrowing capacity in response to changes in their net worth caused by monetary policy adjustments.

In Saudi Arabia, the credit channel is particularly significant due to the dominance of banks in the provision of credit. As interest rates change, banks will typically adjust loan prices accordingly. Government-led initiatives, such as the Kafalah programme, have improved access to credit for SMEs. The availability of credit is further shaped by the role of specialised credit institutions, which contribute to financing priority sectors and advancing economic diversification.

Asset price/wealth channel

The asset price/wealth channel functions through the impact of monetary policy on asset prices, including real estate, equities and bonds. When the central bank reduces interest rates, asset prices typically rise, resulting in an increase in household wealth. This wealth effect boosts consumer spending, as individuals feel more confident about their financial stability.

In Saudi Arabia, the effectiveness of this channel is moderated by government initiatives, such as housing programmes that provide mortgage subsidies. In recent years, however, this channel has become more prominent as real estate ownership levels have grown along with rising prices, thus benefiting property owners. Asset prices in Saudi Arabia have historically been characterised by a stronger relationship with developments in oil markets and fluctuations in public spending. Periods of elevated oil income often result in liquidity surges, leading to increased investments in domestic assets. This dynamic tends to drive up equity and real estate prices, alongside higher levels of consumption. Heightened public expenditure also overshadows the impact of interest rates, boosting aggregate demand and improving investment sentiment (Abdou et al (2024)).

Exchange rate channel

The exchange rate channel plays a major role in open economies, where currency fluctuations can significantly affect trade and inflation. The effectiveness of this channel is influenced by a country's exchange rate regime, the degree of exchange rate pass-through to prices, and the extent of economic openness to international markets.

Saudi Arabia's fixed exchange rate regime serves as a cornerstone of macroeconomic stability and long-term economic planning. Anchoring the exchange rate to the US dollar minimises the impact of exchange rate volatility, fostering stable trade conditions in an open economy where imports of goods and services averaged 28.5% of GDP between 2000 and 2023. Empirical evidence affirms that the exchange rate regime has limited the impact of external inflationary pressures on the economy (Fareed et al (2023)). As such, inflation in Saudi Arabia has averaged around 2% over more than two decades, which compares favourably against inflation levels witnessed in several emerging market economies.[1]

The role of household heterogeneity in monetary policy transmission

Households in Saudi Arabia exhibit notable heterogeneities in their responsiveness to monetary policy adjustments, driven by disparities in inflation exposure, credit access and financial literacy. While credit availability plays a pivotal role in influencing household consumption and investment behaviour, the deposit structure of the banking system reflects a sizeable share of non-remunerative deposits. This acts to dampen the monetary transmission mechanism by reducing banks' sensitivity to policy rate changes. Additionally, fiscal policy, particularly government expenditure, exerts a relatively stronger impact on inflation dynamics by influencing domestic aggregate demand within the Saudi economy, reflecting the key role of public expenditures, whereas the fixed exchange rate moderates the transmission of imported inflation.

[1] Source: IMF data portal for average consumer prices, including G20 emerging market economies.

Moreover, financial inclusion and literacy remain essential for enhancing households' capacity to respond to changes in credit conditions. Recent improvements in access to financial services, primarily via digitalisation, public awareness campaigns and provision of savings products, may have increased households' sensitivity to changes in interest rates. Further analysis of households' heterogeneities is necessary to optimise the efficacy of monetary policy tools for the economy, where fiscal policy often dominates macroeconomic conditions.

Income distribution

Income disparities significantly influence household heterogeneity in monetary policy transmission. Different household segments may not benefit uniformly from rising asset valuations. Geographic disparities further exacerbate these dynamics. Urban households, particularly in major cities, tend to have better access to financial services compared to rural households. Moreover, urban populations are generally more financially aware and sophisticated, enabling them to respond to interest rate conditions. Financial literacy levels vary, with less financially literate households exhibiting weaker responsiveness to changes in interest rates and credit conditions.

Addressing these disparities requires targeted programmes, such as financial education initiatives, to enhance the inclusivity and overall effectiveness of monetary policy. Saudi Vision 2030 programmes include concerted efforts to address these gaps by promoting financial inclusion and enhancing access to formal financial services.

The composition of household income in Saudi Arabia also influences the transmission of monetary policy. Reliance on stable income stabilises consumption, whereas reliance on investment returns or business revenues, which are more sensitive to economic cycles, could leave households more vulnerable to cost of living adjustments.

Labour market dynamics further compound these effects. As of the second quarter of 2024, 66% of the workforce in Saudi Arabia was employed in the private sector, compared to just 19% in the public sector, while the remaining workers are classified as "others".[2] Notably, expatriates comprise 79% of private sector employees, potentially dampening the impact of monetary policy on aggregate demand due to lower remittance retention (NLO (2024)). Among Saudi nationals, however, 49.1% are employed in the public sector, where greater job stability provides increased financial security.

Household spending and consumption

The close alignment between income and consumption levels indicates that a significant share of household spending in Saudi Arabia is directed towards consumption. Furthermore, stable inflation supports the purchasing power of households, while high inflation risks eroding it. Given that Saudi Arabia operates as an open economy under a fixed exchange rate regime, household consumption is

2 Source: General Authority for Statistics (2024). Other sectors include non-profit organisations, domestic workers, regional and international organisations.

indirectly affected by external factors such as imported inflation, which is mitigated to a large degree by the fixed exchange rate policy.

Cultural and demographic factors such as age, family size and regional disparities further influence household financial behaviour in Saudi Arabia. Moreover, younger households and larger families tend to save less, prioritising consumption due to higher dependency ratios, while households in urban areas generally exhibit higher savings due to greater financial literacy and better access to financial services (Alsedrah (2024)).

Initiatives such as expanding access to savings products and encouraging private savings vehicles aim to build a more robust and resilient saving culture across all households.

Household debt levels

Inflation expectations and credit access influence household borrowing decisions, particularly in anticipation of price increases. However, improved availability of granular data in Saudi Arabia is needed in order to enable a more accurate assessment of household heterogeneity in borrowing behaviour, particularly the relationship between inflation expectations and credit access, and its impact on monetary policy transmission.

Household wealth

The composition of household wealth affects the transmission of monetary policy. Housing represents an important component of household wealth in Saudi Arabia, shaped by cultural priorities and government policy initiatives. The Housing Program launched in 2018 aims to expand home ownership through public-private partnerships and streamline access to housing through affordable financing options. These measures have enabled greater household access to the housing market, which has enhanced wealth accumulation through real estate and will foster a more stable asset base in the future.

Certain household segments are more likely to diversify their portfolios through financial assets, whereas other segments often rely on informal saving mechanisms. This disparity underscores the critical role of financial literacy in saving behaviour and household wealth, and their variation across different household segments.

The role of firm-level heterogeneity in monetary policy transmission

Firm-level heterogeneity plays a pivotal role in the transmission of monetary policy, as firms' responses to interest rate changes are shaped by their size and sectoral composition. In Saudi Arabia, SMEs face relatively higher borrowing costs and limited access to credit markets compared to larger firms.

Sectors such as manufacturing and tourism tend to exhibit higher sensitivity to credit availability and interest rate adjustments due to their reliance on bank lending, cyclical demand conditions and broader economic activity. On the other hand, firms in sectors heavily reliant on government spending, including construction and renewable energy, experience weak transmission of monetary policy due to their dependence on public expenditures.

Empirical studies have found that firm-specific characteristics, including age, size and sectoral affiliation, determine their vulnerability to monetary policy adjustments. Younger and smaller firms are asymmetrically affected by interest rate hikes, reflecting their reliance on limited funding sources. In contrast, larger, well established firms benefit from economies of scale and superior access to credit, with diverse funding sources. Furthermore, high-growth firms often bypass traditional credit markets, relying on alternative financing mechanisms and thereby reducing the risk of interest rate shocks (Thurwachter (2022)).

Measures to address heterogeneity

Owing to the role of fiscal policy, the Saudi government has implemented a range of targeted initiatives to address economic heterogeneity. Programmes such as the Beneficiaries of Social Welfare Program provide financial assistance to individuals and families in need, ensuring access to basic necessities and promoting social welfare. The Hafiz Program delivers financial support and training to unemployed Saudis, enhancing employability and fostering workforce participation. Similarly, the SANED Program, an unemployment insurance scheme, mitigates income shocks by offering temporary financial assistance and facilitating re-employment opportunities. Moreover, to alleviate the financial burden on certain household segments, the Citizen's Account Program safeguards Saudi households from the adverse impact of economic reforms by offsetting the cost of living through targeted cash transfers. Collectively, these programmes aim to narrow economic disparities and enhance support for low-income households.

Meanwhile, SAMA promotes savings and financial literacy through targeted campaigns and strategic partnerships with financial institutions. Efforts to improve access to financial services include the promotion of digital payments, the expansion of digital banking, and initiatives to foster financial awareness. To ensure sustainable household borrowing, SAMA actively monitors debt levels and has established clear guidelines for responsible lending, which were introduced in 2018. Moreover, government-backed initiatives have played a pivotal role in reducing the adverse impact of interest rate fluctuations on SMEs.

Through these coordinated measures, SAMA and the government aim to address financial inequalities, promote inclusive credit access and strengthen financial stability.

Conclusion

In Saudi Arabia, interest rate transmission to the real economy remains limited, largely due to structural factors. In contrast, the exchange rate channel has proven effective in restraining inflation and there is a measurable pass-through from the credit channel to the real economy. Fiscal policy plays a dominant role in driving economic activity, supported by ongoing economic reforms.

Heterogeneity across households and firms is often overlooked in monetary policy decision-making, despite its growing importance in understanding the differentiated impacts of policy measures across economic segments. More granular data that capture such heterogeneities would help in developing economic policies that better address the diverse behaviour of economic agents.

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