Changing patterns of financial intermediation: Implications for central bank policy

Financial intermediation in Saudi Arabia

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Abstract

In Saudi Arabia, financial intermediation has further increased over the last few years as banks continue to dominate the supply of credit to both the corporate sector as well as households. Bank balance sheets have continued to grow owing to heavy public spending and accelerating private sector activity in recent years. Banks' total assets were equivalent to three quarters of GDP in 2014. Saudi Arabia's countercyclical approach in fiscal and monetary policies helped dampen the effect of oil price volatility on the banking sector and overall economic growth. Moreover, SAMA has been able to maintain financial stability through the use of various monetary policy tools and its orthodox application of macroprudential measures. As for interest rate policy, it will broadly continue to follow developments in US policy rates given the pegged exchange rate to the US dollar. For Saudi Arabia, SAMA policy rates and macroprudential factors characterise the policy framework that has allowed SAMA to prudently manage the liquidity in the system.

Keywords: Financial intermediation, banking sector, bank credit, monetary policy

JEL classification: E510

Background

The Saudi financial system currently comprises the Saudi Arabian Monetary Agency (SAMA), 24 banks with a network of 1,931 branches, a stock exchange, five specialised credit institutions (SCIs),[1] and other non-bank financial entities, such as securities and brokerage firms, insurance sector and finance companies. Key financial products include corporate stocks and bonds, government bonds, SAMA bills, financial derivatives, and some Islamic products (eg sukuk). In common with other emerging economies, banks still dominate provision of credit to the private sector, accounting for 96.6% of total bank credit in February 2015. There is some evidence that banks are lending on a longer-term basis. Lending to households has been growing in importance. Bank balance sheets have continued to grow on the back of accelerating private sector activity and a high rate of public spending in recent years. The asset base of the banking sector expanded by an annual average growth rate of 10.3% to SAR 2.1 trillion ($568.7 billion) during 2007–14. In 2014, banking assets stood at 75.6% of GDP.

Banks and SCIs are the key credit suppliers in Saudi Arabia. Banks' role relative to that of SCIs has strengthened over the years. The importance of the banking sector can be judged by an uptick in the money multiplier from 5.9 in 2012 to 6.1 in 2014.

Financial intermediation and central banking post crisis

Globally, there has been a noticeable change in both financial intermediation and central banking operations. In advanced economies, the deleveraging of bank balance sheets had a negative impact on credit growth and economic activity. In EMEs, which are mostly bank-centric, the outcome was mixed. These developments have influenced central bank operations, leading them to adopt unconventional policies in advanced economies resulting in expanded balance sheets while also tightening prudential measures. EMEs have likewise tightened prudential measures but have not adopted unconventional policies. In Saudi Arabia, bank credit growth has been brisk, reflecting a gradual secular deepening of the financial system, against an environment of strong overall economic activity backed by steady fiscal spending without triggering inflationary pressures. This is because bank credit growth and risk exposure are subject to strictly enforced prudential measures.

The financial sector plays an important role for economic growth. A lesson learnt during the recent financial crisis is that too large a financial sector brings about fragility and too small hampers real growth. There is no useful theory on the optimal size of the financial sector, but the recent episodes are indicative of the fact that a highly overleveraged banking sector far in excess of nominal GDP does not augur well for financial stability. In Saudi Arabia, the banking sector is equivalent to three quarters of national GDP, reflecting modest leverage and a high capital cushion, and this is likely to grow as financial deepening continues.

[1] The SCIs comprise the Agriculture Development Fund, the Saudi Credit and Saving Bank, the Public Investment Fund, the Saudi Industrial Development Fund, and the Real Estate Development Fund.

The post-crisis preoccupation is how far to go in regulation versus the danger of damaging the process of bank intermediation. Is the regulatory trajectory getting so overwhelming that it affects economic growth or is the cost worth bearing for maintaining long-term financial stability and economic activity? In our view, the latter argument is stronger. In Saudi Arabia, the application of prudential measures by a single strong regulator, which is also responsible for monetary policy (ie SAMA) has not only kept the banking sector resilient but has also helped stabilise economic growth over time.

Implications for monetary policy

Saudi Arabia is a fiscally dominant economy, where the budgetary stance is countercyclical by design: it either stimulates growth (when deficits are run) or dampens it (by running surpluses) in order to stabilise the growth path of the economy. Monetary policy plays a supporting role. As SAMA's monetary policy is anchored in the stability of the USD/SAR exchange rate through the pegged regime, combined with an underborrowed economy, which has an emerging market status, the interest rate lever has limitations. In addition, SAMA sets reserve requirements and engages in repo and reverse repo transaction. Because of the limited supply/stock of government and corporate debt, SAMA issues SAMA bills to regulate liquidity and credit conditions. In terms of policy effectiveness, macro- and microprudential measures have played an important part in preserving financial stability. This is evidenced by the fact that Saudi Arabia has not had to undertake extraordinary steps to support the financial system or to boost bank intermediation.

Going forward, what remains debatable is whether central banks should intervene vis-à-vis asset price pressures. In the case of Saudi Arabia, the answer currently is in the negative, given that factors influencing asset prices tend to be beyond the remit of the central bank (eg land and housing supply).

In conclusion, Saudi Arabia's countercyclical approach in fiscal and monetary policies helped dampen the effect of oil price volatility on the banking sector and overall economic growth. Moreover, SAMA has been able to maintain financial stability through the use of various monetary policy tools and its orthodox application of macroprudential measures. As for interest rate policy, it will broadly continue to follow developments in US policy rates given the pegged exchange rate arrangement to the US dollar. For Saudi Arabia, SAMA policy rates and macroprudential factors have characterised a policy framework that has allowed SAMA to prudently and effectively manage the liquidity in the system.