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SIBOR Review

Is this the new norm?

In unusual fashion Saudi Arabia have raised its key interest rates last week ahead of the Federal Reserve tightening that occurred yesterday. The kingdom Monetary Authority, known as SAMA, increased its repurchase (first time since 2009) and reverse repurchase rates by 25 basis points each, to 225 and 175 basis points, respectively.

by Faisal AlJaser
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The major difference this time than on previous occasions, is that SAMA tended to follow the Fed rather that anticipate the move.

The change of track can be seen in conjunction with the Fed rate hike expectation for this year and the latest U.S London Interbank Bank Offered Rate (LIBOR) momentum. Since the global financial crisis in 2009, the Saudi Riyal Interbank Average Offered Rate (SIBOR) for three months, which is the most liquid, has never been outpaced by its U.S counterpart up until last month. It currently stands at 5.36 basis point discount as of the time of writing this article. Economists say the discount could result in capital outflows or deposits being shifted from Saudi riyals to U.S. dollars.

It is worth noting that the SIBOR is inclined by SAMA policy rate which is the Reverse Repo Rate. In return, the Kingdom policy rate is set with reference to the US Fed target rate.

This arrangement necessitates SAMA's policy rate to follow closely the US Fed rate to avoid any potential pressures that could emerge on the peg because of more likely capital in- or out-flows. When looking at the three months pair, the average spread for the last ten years has been around 58 basis points in favour of SIBOR as demonstrated in Figure 1 (3 months SIBOR vs 3 months LIBOR).

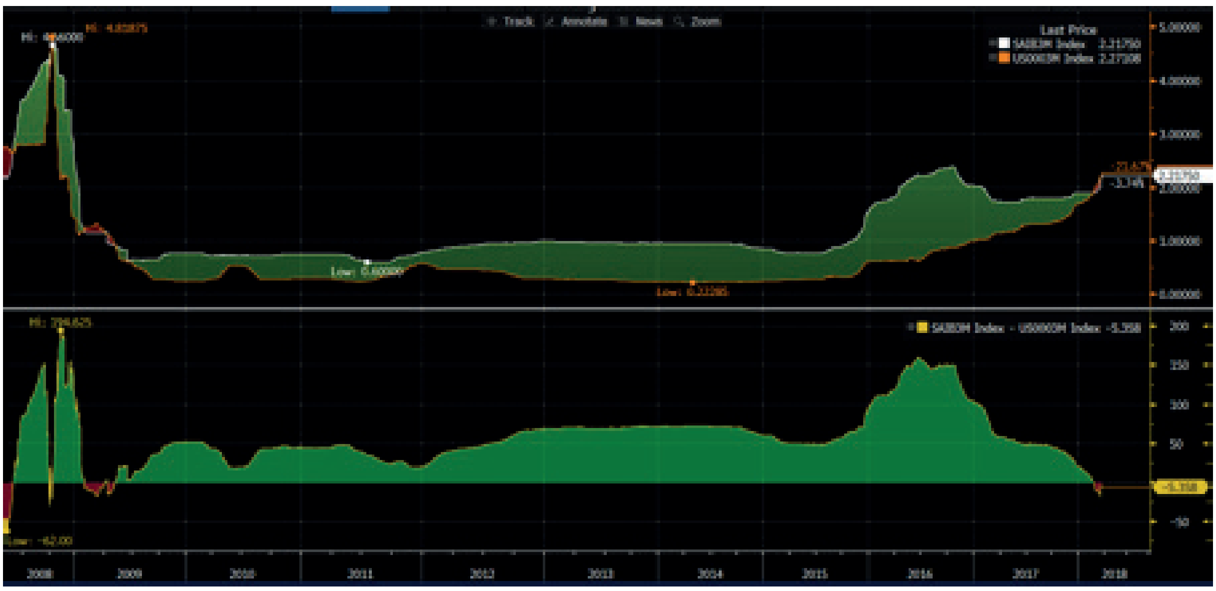
The SIBOR can also be significantly affected by the local liquidity stance as seen in 2016 amid the crash of oil prices, as within the span of a year, three months SIBOR have increased by around 140 basis points (approx. 141%).

Comparatively, LIBOR have moved by 54 basis point (approx. 165%) with one FED rate hike happening in that same span of time. It's important to know that at a certain time in 2016, the SIBOR was about 150 basis point higher than its U.S equivalent.

This year the local banking liquidity is seen as sufficient when compared to the last two years. However, credit growth to local private companies is relatively slow according to recent data issued by SAMA. Furthermore, the kingdom has witnessed a period of deflation that lasted for most of 2017.

Hence, we believe that most of the recent SIBOR upward movements are the result of a U.S hawkish monetary policy accompanied with an increased global appetite on US Treasuries. Due to the peg, obviously there is a strong positive correlation between the policy rates of both SAMA and the FED. However, applying some statistical regression analysis to verify the same assumption when it comes to both countries intebank rates using a period that covers rates hikes post financial crises in 2009 (771 observation), showed that only 21% of SIBOR movements can be explained by movements in the U.S LIBOR in which consequently resulting with a weak positive correlation (below 0.50). Nonetheless, we believe this mismatch in Interbank rates is expected and is the product of a temporarily divergence in both liquidity and inflation stance between the two countries.

Figure 1



Source: Bloomberg

The U.S inflation is expected to trend higher and meet its target of 2% in 2018 as an upside risk of fiscal stimulus and near full employment position steady at 4.1%.

Also looking at the current implied probabilities of future FED hikes, we would believe that it is reasonable to assume at least two additional 25 basis points FED rate hikes are on the way this year. We are also of the view that the Federal Open Markets Committee in its coming meetings will likely reaffirm its plans to gradually reduce the size of its balance sheet.

Adding to the mix, the expected continued global demand for U.S risk free securities will keep supporting the demand for the U.S Dollar, which will further insure adequate liquidity levels and an upward trend in U.S rates, specifically the LIBOR.

A major risk for this monetary policy to continue in its planned momentum is the possibility of outcomes that can arise from the current trade war the U.S are launching in which the FED chairman Jerome Powell have made sure in yesterday's conference to dodge digging deep into the matter and clearly emphasising the fact of it being an issue under the trade administration.

On the other hand, the Saudi economy have most likely contracted by 0.7% in 2017 (official numbers are yet to be published) and real GDP growth is expected to average just around 2% a year over the next three to four years according to various sources.

Inflation in 2018 is expected to rise to an average of 4.4% after a period of deflation that continued for most of 2017.

The expected increase of inflation will be the result of fresh fuel and electricity subsidy cuts, which will have an impact on the general price level, and, equally important, the recent introduction of value-added tax (VAT).

Saudi banks' lending to private companies shrank for an 11th month in January, the longest stretch in at least two decades.

Total credit issued to private companies fell 1 percent from a year earlier, compared with a 41 percent jump in lending to the public sector -- the most in 11 months.

SAMA's total net foreign assets fell 2.1 percent to $486 billion, the first monthly decline since September, led by a drop in the value of investments in foreign securities.

Non-Oil activity have weakened in January according to more than monetary and financial indictor, such as ATM cash withdrawals, cheques bank clearing, and point of sale transactions which can suggest a slow consumer consumption.

Nonetheless, we believe with the current Oil levels and increased government spending as predicted by the 2018 expansionary budget, better growth is expected ahead.

In light of the above, its seems somehow clear that any future increases in SAMA policy rate and accordingly SIBOR will be counterproductive to the overall economy on the short to medium term and up until the local economy gain some momentum.

Notwithstanding, we believe that this will be the new norm going forward in tandem with any increases in the U.S as shown in Figure 2 (SAMA Reverse Repo vs U.S Fed Target Rate – Upper Bound).

As we are of the view that SAMA will continue to preserve the currency stability and the attractiveness of the Riyal as was the case in periods of pre-global financial crises when the local stock exchange crashed in 2006.

That can be seen as rational considering the other alternatives. For the benefit of SAMA, we can say it has the appropriate tools to manage the SIBOR in either direction bearing in mind the anticipated sovereign debt issuances and prospects of it targeting the local or international markets.

Moreover, it can possibly tap the banks reserves ratios or control the money supply via open market operations. To boost banking credit growth, SAMA has actually started the work on a new incentives pertaining to the calculations of the loans to deposits ratios (LDR).

That being said, we are just curious how the Saudi economy will react with this cyclical approach given that the existing setting and dynamics are pretty much different to those which were present in times of similar economic divergence.

Figure 2

Source: Bloomberg

ABOUT EHATA

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