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Fundamental disconnect II

- Saudi Monetary Authority cut reverse repo rate by 50bps to 4.25%
- The reverse repo rate is now below Fed Fund rates
- This could work as an incentive to place excess liquidity in USD's than riyal

Saudi Arabia

The events

The Saudi Arabia Monetary Authority (SAMA) cut the reverse repurchase rate over the weekend by 50bps, from 4.75% to 4.25%. In order to put SAMA's decision in context, one needs to consider two main factors. First, with the USD peg in place, Saudi Arabia is importing monetary policy from the US. With this new cut, SAMA has now matched the 75bps interest rate cuts we have already seen in the US.

Second, Saudi Arabian markets are characterised by ample Saudi Riyal (SAR) liquidity, and very tight USD liquidity. The ample SAR liquidity is related to both the low interest rate environment, but also the market expectation of a possible revaluation. On the other hand, tight US dollar liquidity is a global phenomenon which is directly related to the credit crunch in the US. SAMA seems to be concerned about this. And contrary to what conventional economics would suggest, the 50 bps cut is probably aimed towards reducing the excess SAR liquidity in the interbank market. The reverse repo rate is now below the Fed funds target rate by 25bps and it is possible that SAMA might want to encourage local banks to switch from SAR to USD which offers the higher rate. This, on its own, is unlikely to be effective, as part of the reason why locals want to hold SAR, is related to the expectation of a revaluation. It is however possible to see more direct steps of the SAMA to drain SAR liquidity out of the system and inject USD liquidity.

Market Implications

At the moment, swap rates in Saudi Arabia are much lower than the policy rates. This is because of three reasons. First, market expectations of a SAR revaluation which are driving USD-SAR forward rates lower, second, ample SAR liquidity, and third the global tightening in USD liquidity. To illustrate this one can look at the 1-week swap rate, which is close to 0% and the 1-week deposit rate which is around 4.25%. In normal, liquid conditions, one could borrow at the near zero rate and deposit at the 4.25%. However, because of tightening liquidity conditions when it comes to the USD, there is a reluctance to give away USD's in order to borrow SAR, even at the near 0% levels. This difference between policy and money market rates on one hand and swap rates on the other is an anomaly and it is a direct result of the three factors we discussed above.

The rate cut by the SAMA is an indication that the authorities are concerned with the underlying factors behind this anomaly, particularly the different liquidity conditions in SAR and USD. If the authorities are successful in draining SAR liquidity and providing USD liquidity, then the swap rates should start converging toward the policy rates. We believe that a 25bps cut is unlikely to be enough, so there is a possibility that SAMA could start providing USD liquidity more directly into the system. This would have a short term impact on forward rates, which could rebound higher.

Despite the short-term management of domestic SAR liquidity and the provision of USD liquidity, the fundamental challenges for the Saudi authorities remain. The Fed is cutting rates, and the USD is weakening. This is providing a monetary stimulus to the Saudi economy, at a time when the economy needs policy tightening. Market expectations for a revaluation are related to this fundamental disconnect, and any short term rebound in the forwards could be seen by the markets as an opportunity to re-enter at more attractive levels.

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