

Role and Economic Impact of Interest Rate as a Tool of Saudi Monetary Policy in Light of the International Financial Crisis

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Abstract:

This study aims to investigate the role of the interest rate in the Saudi monetary policy and its impact on the Saudi economy during the international financial crisis. The research methodology is descriptive and analytical, and the secondary data collected for this study include descriptive statistics, specifically, means, standard deviations and percentages. The study concluded that changes in interest rates by the Saudi Arabian Monetary Agency (SAMA) have resulted in both positive and negative repercussions on the Saudi economy. On the one hand, the reduction in interest rates, for the most part, has resulted in low costs for credit, improved liquidity, increased credit access for small- and medium-scale enterprises, and promoted competitiveness with respect to exports. On the other hand, raising interest rates has resulted in high costs of credit for companies, improved the profitability of banks and increased the exchange rates with respect to the Saudi riyal (SR). The Saudi monetary policy is restricted by the following two factors: the pegging of the SR with the US\$, which has limited the role of interest rates in the Saudi monetary policy, and the dual banking system of traditional and Islamic banks, where traditional banks are affected by changes in interest rates while Islamic banks are not because interest is prohibited by Sharia law.

One of the alternatives for the Saudi monetary policy to be more independent is to peg the SR to a basket of currencies.

Key words: Interest Rate, Monetary Policy, Saudi Arabia

SECTION I: INTRODUCTION

1-1 Preface

There is current controversy among economists and financial analysts regarding the role of the interest rate as a tool for monetary easing and the tightening of policies; its impact on stimulating economic growth, employment and liquidity; and its ability to control inflation. Moreover, the controversy continues as to whether easing the monetary policy should be terminated due to its burden on the government budget and public debt, which exceeded \$14 trillion in the US.

Since 2008, central banks in the US, the Euro zone, the United Kingdom, Japan and China used changes in interest rates as a tool for controlling inflation, employment, economic growth and aggregate demand.

In December 2015, the US Federal Reserve Bank adopted a more stringent monetary policy by gradually increasing interest rates over several years by 0.25% (and then 0.50%) until the rates reached 3.5%. This practice was followed by other countries, particularly those that peg their currencies to the US\$, such as Saudi Arabia and other Gulf Cooperation Council (GCC) countries.

Various scenarios are open to the Saudi monetary authority (SAMA), and, thus, the SAMA is willing to change the interest rates as a tool of monetary policy to control inflation, stimulate economic growth, generate employment and increase aggregate demand.

1-2: Research Problem

The research problem stems from the significance of using the interest rate as a tool of Saudi monetary policy in light of pegging the Saudi riyal to the US dollar and the impact of changing interest rates on the Saudi economy. Thus, the research problem is formulated in the following research questions. (1) What is the role of the interest rate in the Saudi monetary policy? (2) What is the impact of changing the interest rate on the Saudi economy?

1-3: Research Objectives

The research objectives are as follows: (1) to investigate the role of the interest rate as a tool of the Saudi monetary policy and (2) provide information regarding the impact of the changing interest rates on the Saudi economy during the international financial crisis between 2008 and 2015.

1-4: Research Importance

The research significance stems from the scarcity of research on the role and impact of using interest rates as a tool of the Saudi monetary policy and the importance of the conclusions and policy implications of the study for decision makers of monetary policies, financial analysts and economic researchers.

1-5: Research Methodology

The research methodology, which is both descriptive and analytical, analyses secondary data and presents results in terms of means, standard deviations, percentages and mathematical equations.

1-6: Research Limitations

There are two limitations to consider. First, the study period is limited to the years of the international financial crisis (2008 to 2015), the lack of primary data and empirical research due to

the exploratory nature of the study limits the depth of the study.

1-7: Research Organization

The organizational structure of the study includes five sections. Section I presents the introduction. Section II presents the conceptual framework of interest rates and previous studies. Section III presents the salient characteristics of Saudi monetary policy. Section IV presents an analysis of the role and economic impact of interest rates on the Saudi monetary policy (from 2008 to 2015). Section V presents the conclusions and policy implications. The references and an appendix complete the paper.

SECTION II: CONCEPTUAL FRAMEWORK OF INTEREST RATES AND PREVIOUS STUDIES

Interest is defined as the rate of return on capital as a factor of production or the price that is paid by borrowers to lenders for the use of their (lenders) savings. In other words, interest is the price that the consumer asks to compensate for delayed consumption for a specific period. The interest rate is the compensation required by the owner of the capital for the loan to the customer (Ahuja: 2006).

Interest is classified as the nominal rate of interest, i.e., the rate that prevails in the market, and the real interest rate, which is the nominal rate of interest adjusted for inflation, as in the following equation:

$$\text{Real interest rate} = \text{Nominal interest rate} - \text{Inflation.}$$

Other types of interest include simple and compound rates of interest, where the simple interest rate is calculated on the principal amount of the loan, and the compound interest rate is

calculated on the principal amount plus the interest accrued on the loan.

There are three economic theories that explain the determinants of the interest rate. The classical theory of interest stresses that interest is determined by demand and supply of savings for investment purposes. The neoclassical loanable fund theory posits that the determinants of the interest rate are based on the equilibrium between the demand and supply of loanable funds. The last theory, the Keynesian interest theory, contends that the interest rate is determined by the equilibrium between the demand and supply of money. The Keynesian theory of interest is also known as the liquidity preference theory where demands for money are made based on three specific motives, namely, transactions motive, precautionary motive and speculative motive. John Keynes described the liquidity trap, which results when the central bank cannot increase the money supply once the interest rate reaches a minimum level of zero. The liquidity preference theory promoted by John Keynes explains the changes in interest rates (Ahuja: 2006).

Other determinants of the interest rate include money supply; inflation and discount rates charged by the central bank when providing loans to banks; the business cycle of recession, boom, prosperity and depression; and the expansions and contractions of the monetary policy.

The central bank usually fixes the interest rate as an indicator of the bank's decisions regarding interest on deposits, loans and interest margins. Other concerns regarding interest are its impact on savings, investments, credit facilities and credit access, bond returns, discount rates on repos, reverse repos, and the liquidity of the banking system (Begg et al.: 2011).

According to Samuelson and Nordhaus (2005), changes in interest rates have an impact on the exchange rate of a currency that, in turn, affects exports, imports and foreign

direct investments in a country where high interest rates lead to currency appreciation, whereas the opposite holds in the case of low interest rates.

The US Federal Reserve Bank will raise interest rates in the event of monetary tightening, whereas it will lower interest rates, known as monetary easing, to influence aggregate demand, inflation, employment and economic growth. Furthermore, determinants of interest rates in emerging markets include concentration ratios, costs of economic restructuring, and direct and indirect monetary policies that impact company profits (Ozdemir & Altinoz: 2012).

Based on the economic theory, the equilibrium interest rate is determined by the cross point of the money demand and money supply curves. Interest rates will be low when money demand declines and high when demand for money increases. The greater the money supply, the lower the interest rate, and vice versa (Samuelson & Nordhaus: 2005).

Milton Freidman of the Chicago School of Economics explained how the increase in money supply and the reduction of taxes leads to increased economic activities and changes in prices, as specified by the quantity theory of money (Samuelson & Nordhaus: 2005).

$$M V=PQ$$

where

M= Money supply

V=Velocity of money

P= Price level

Q=Size of economy or output

The equation indicates that increasing the money supply leads to higher prices if the velocity of money and the output remain constant.

As a consequence of the international financial crisis, the US Federal Reserve Bank initiated a monetary easing plan beginning in 2008 by lowering the interest rate to 0.25% and expanding the supply of money to encourage companies to

borrow, and thus move towards ending the economic recession. Monetary easing was accompanied by the purchasing of government bonds and the encouraging of commercial banks to borrow from the Federal Reserve Bank through the Security Lending Facility to eliminate the liquidity trap that allows banks to borrow using their security guarantees under the Asset Relief Program. In December 2015, the Federal Reserve Bank initiated a money tightening plan by raising the interest rate to 0.50% after the US economy had achieved economic growth, reduced the unemployment rate to 5% and lowered the inflation rate to less than 2%. According to the plan, the interest rate will increase gradually until it reaches 3.5% in 2017 (Yelen: 2015).

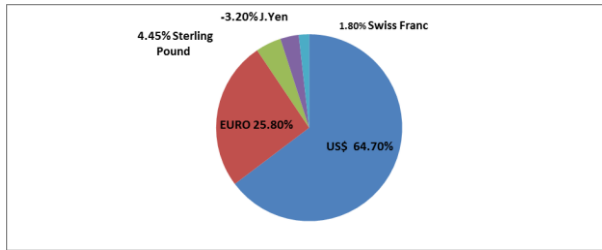
As a reaction to the increasing interest rate on the US dollar, central banks in the Euro zone and Japan responded to the Federal Reserve Bank's monetary tightening by increasing their interest discount rates (Edwin: 2009).

To fight the recession, the Central European Bank extended the money easing policy in the EURO Zone to 2017, with interest rates falling below 0.25%. Moreover, the Central Bank of Japan followed the monetary easing policy by lowering its interest rate and buying government bonds to cope with Japan's recession. The China Central Bank lowered the value of its Yewan currency and lowered its interest rate from 2% to 1.5% to increase export competitiveness (Al-Watan: 2015).

Money easing is relatively new and differs from the traditional monetary policy when dealing with recessions (http://en.wikipedia/quantitative_easing.com.)

The US dollar constitutes a high percentage of the reserves of international currencies, as presented in Figure 1.

Figure 1: Shares of Main Currencies in International Reserves



Source: IMF (2015) Financial Statistics. Washington DC.

Moreover, the US dollar plays an important role in foreign trade and the global payments system, as presented in Table 1.

Table 1: Role of US \$ in Foreign Traded and Global Payments System

Item	Percentage/Value
Global Exports in US\$	50%
Share of US\$ in International Reserve	64%
Size of Transaction in US\$	US\$ 3 trillion

Source: IMF (2015) Financial Statistics. Washington DC.

Interest on the US\$ has fluctuated in the last decade, as presented in Table 2.

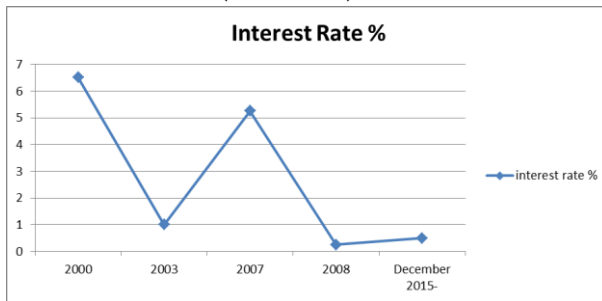
Table 2: Development of Interest Rates in the US between 1997 and 2015

Year	Interest Rate	Reasoning
1997 - 2000	6.5%	Dot Com. Bubble
2001-2003	1.0%	Recession
2004-2007	5.25%	Mortgage of Housing Bubble
2008-2015	0.0%-0.25%	International Financial Crisis
December 2015-	0.25-50%	Monetary Tightening Policy

Source: Federal Reserve Bank (2015) Declining and Rising Interest Rates on Federal Funds. Washington D.C.

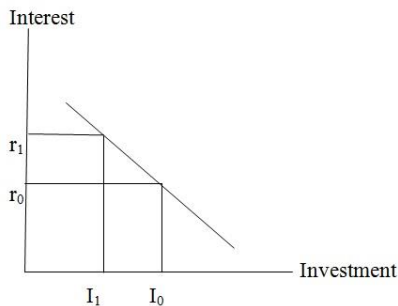
Interest Rates in the US for the period 1997 to 2015 are presented in Figure 2.

Figure 2: US Interest Rates (1997-2015)



The impact of raising the interest rate in the US strengthens the dollar, increases the value of assets valued in US dollars and increases the values of currencies pegged to the US dollar. Furthermore, higher interest rates reverse the negative impact on consumption and investment, as indicated in Figure 1 (Begg et al.: 2011).

Figure 1: Function of Interest Rate



Quantitative monetary easing, which was introduced to overcome the global financial crisis, has the following implications: (1) collapse of mortgage market, (2) lack of bank lending, (3) lower bank reserves, (4) lower aggregate demand, (5) lower capital adequacy ratio, (6) lower bonds prices, (7) lower investment and consumption, which are parts of aggregate demand, (8) lower economic growth an onset of recession.

Our literature review summarizes eight studies on monetary policy.

1-The study by Henry C. Murphy (1950) *Role of Interest Rates in a Changing World: Reappraisal of Easy Money*. This study concludes that interest rates have a twofold function. Specifically, interest rates are positively related to savings, i.e., the higher the interest, the greater the savings, and interest rates are negatively related to investments, i.e., high interest rates discourage real investments. Furthermore, high interest rates curb excessive credit creation; i.e., if interest rates are too high, bank credit contracts and prices increase. Moreover, high interest rates have a negative impact on capital formation due to the negative impact of interest on investment. The study also concluded that in times of emergency, interest rates are not an appropriate measure for allocating funds to the public and private sectors.

2- The study by Phillip C. James (2014) *Sector Rotation and Interest Rate Policy*. This study concluded that a sector rotation strategy based on changes in interest rates is one way for investors to maximize their returns. The study used US monthly bank prime loan rates from January 31, 1949 to December 31, 2012 to measure changes in interest rates that were labelled as either expansionary or restrictive. Beta values were used to measure portfolio risks and were obtained by regressing monthly equally weighted returns against the monthly Dow Jones industrial index. The study concluded that a sector rotation strategy based on changes in interest rate adjustments can improve the performance of investors' portfolios.

3- The Study by Nilufer Ozdemir and Cuneyt Altinoz (2012) *Determinants of interest rate for emerging market economies: the role of financial market structure*. The study concluded that

it is essential for central banks to assess whether the pass-through from monetary policy rates to credit and deposit interest rates is complete to ensure price stability. Emerging market countries lack the large panel datasets that are typically available for developed countries, thus making it difficult to analyse the determinants of pass-through coefficients for emerging markets. The findings indicate that competition among banks plays a more important role for emerging market countries than for their developed counterparts.

4- The study by Khalil Abdelrahim and Farid Flemban (2009) *Economic Feasibility of Pegged Riyal to US Dollar & Options for Adjusting Saudi Foreign Exchange System in Light of Recent Economic Developments*. The study concluded that the Saudi Arabia Monetary Agency (SAMA) is no longer in control of its monetary policy due to the pegging of the Saudi riyal (SR) with the US dollar since 1986 when SAMA was obliged to change its interest rate to match the changes in the interest rates of the US Federal Reserve Bank. The study recommended that to increase the control of SAMA over the Saudi monetary policy, the riyal should be pegged to a basket of currencies that includes the US dollar (40%), the euro (30%), the sterling pound (10%) the Japanese yen (10%), the Swiss franc (5%) and the Special Drawing Right (5%).

5- The study by the Arab Monetary Fund (2015) *Developing Arab Bond Markets*. The study concluded that bond returns are affected by the market interest rates. Bonds markets in the Arab countries are weak compared with stock markets. Bond markets, which are considered sources of finance in the medium and long terms, support the role of banks in providing financing to economic sectors, particularly long-term financing. Sukuk, which is an alternative to the bond, is used as a tool for Islamic

financing, is growing rapidly and expected to soon reach approximately US\$ 1 trillion world-wide.

6- The study by the Mackenzie International Consultative Institute (2015) Saudi Arabia Far Away from the Oil Sector. The study concluded that the KSA should identify the areas of disequilibrium in the Saudi economy and develop a strategy through the year 2030 that diversifies its economy away from the current 90% share of oil in the economy to 30% by 2030, creates six million jobs for the Saudis, increases the per capita income by 60% by the year 2030, invests 1 trillion riyal over the next 15 years through the private sector, privatizes certain government projects to raise productivity, increases training of human resources and attracts more foreign investments.

7-The study by Fahd Ben Abdullah Alhwimani (2015) Impact of the American Monetary Policy upon Saudi Monetary Policy. The study concluded that the changes in the US monetary policy created challenges for the Saudi Arab Monetary Agency (SAMA) due to the pegging of the riyal to the US dollar since 1986 despite the differences in economic structure between the two countries. Interest on deposits in the KSA was reduced to 1.5% when the US lowered interest rates to nearly zero, leading to more lending by Saudi banks, and when the US Federal Reserve Bank increased the interest rate from 0.25% to 0.50%, the SAMA increased the interest rate on reverse repos to 0.50%, which led to an increase of the interest on loans between banks (SIBOR) to 1.3%, which caused an increase in the borrowing cost. Such an interest change resulted in pressure on the SR exchange rate, thus negatively impacting exports.

SECTION III: SALIENT CHARACTERISTICS OF SAUDI MONETARY POLICY

The structure of the Saudi banking sector consists of the Saudi Arab Monetary Agency (SAMA), which was established as an independent legal entity that licensed banks operating in the KSA, which consists of 20 banks including Saudi banks, joint ownership banks and foreign banks, as presented in figure (1).

Figure (1) Structure of Saudi Banking System

Saudi Arab Monetary Agency (SAMA)					
Saudi Banks	No. of Branches	Joint Ownership Bank	No. of Branches	Foreign Banks	No. of Branches
1-National Commercial Bank (Ahli Bank)	284	9-Saudi Dutch Bank	42	14. International Gulf Bank	2
2-Al-Rajhi Bank	442	10- Saudi American Bank "Samba"	67	15-Emirate Bank	1
3-Riyad Bank	216	11- Saudi British Bank "SABB"	72	16-B. NB Perbia Bank	1
4- Albillad Bank	67	12- Saudi Fransi Bank	77	17-Morgan Bank	1
5- Al-Jazira Bank	48	13- Arab National Bank	139	18-National Kuwait Bank	1
6- Alinma Bank	75			19-Bahrain Bank	1
7- AudiInvestmentBank	63			20-Masqat Bank	1
8-Saudi Credit & Savings Bank	NA*				

Saudi Arabia Monetary Agency (2010) Annual Report No. 46. Riyadh. *NA: unavailable source

The Saudi riyal is a convertible currency that is pegged to the US\$ with a fixed exchange rate of 3.75 SR per US\$ since 1986, a situation that restricts the role of the Saudi monetary policy. Interest rates are used by the SAMA to determine interest rates of repurchase agreements, called repos and reverse repurchase agreements, called reverse repos, interest on one-night loans among banks called OVERNIGHT RATE as well as

interest rates on deposits, loans and interest margins, all of which impact bank profitability.

As most revenues of Saudi Arabia come from oil exports that are evaluated by the US dollar, the KSA has pegged its riyal to the US dollar, thus restricting the role of the Saudi interest rate as a tool of the monetary policy for the last 30 years. However, pegging the SR to the US\$ helped to stabilize the SR exchange rate at 3.75 per US dollar.

It is further noted that the role of interest in the Saudi economy is limited compared to the role of the fiscal policy, which plays a greater role in the economy. Monetary indicators in the KSA are presented in Table 3.

Table 3: Indicators of Saudi Monetary Policy from 2007 to 2015

Years	Inflation%	SIBOR 3 months %	Liquidity Growth%	Banks Deposits Growth%	Credit Growth%	Velocity of Money	Money Multiplier	Foreign Reserves Trillion SR
2007	4.1	4.9	23.7	21.4	21.4	1.3	5.4	NA
2008	9.9	3.3	19.0	17.9	27.1	1.2	5.5	NA
2009	5.1	0.9	6.5	11.2	0.0	1.2	5.6	NA
2010	5.3	0.7	9.3	4.7	5.7	1.3	5.4	NA
2011	4.9	0.7	15.4	12.1	10.6	1.2	5.1	NA
2012	4.9	0.9	13.6	14.2	16.4	1.2	5.1	NA
2013	3.5	1.0	11.1	11.2	12.5	1.2	5.3	2.750
2014	2.7	0.9	14.6	12.4	11.8	1.1	5.4	2.665
2015	2.3	0.8	10.2	7.1	9.4	1.1	5.4	2.710

Source: Saudi Arabia Monetary Agency (2015) Monetary Indicators. Annual Reports of SAMA during 2007-2015. Riyadh. NA=unavailable

Results of Table 3 indicate the following: (1) a decline in inflation from 9.4% in 2008 to 2.3% in 2015; (2) a fluctuation in the SIBOR rate from 4.9% in 2007 to 0.8% in 2015; (3) a range in bank liquidity from 23.7% in 2007 to 10.2% in 2015; (4) a range in the growth of bank deposits from 21.4% in 2007 to 7.1% in 2015; (5) a range in credit growth to the private sector from 27.1% in 2008 to 9.4% in 2015; (6) a range in the velocity of the riyal from 1.3% in 2007 to 1.1% in 2015; (7) a fluctuation in the monetary multiplier from 5.1 in 2007 to 5.4 in 2015; (8) a

fluctuation in foreign reserves from SR 2.6 trillion to 2.7 trillion.

The KSA has a dual banking system where traditional banks use interest rates in their operations, but Islamic banks do not apply interest as it is prohibited by Sharia law. Accordingly, traditional banks are affected by changes in interest, whereas Islamic banks are not.

SECTION IV: ANALYSIS OF ROLE OF AND ECONOMIC IMPACT OF INTEREST RATE ON SAUDI MONETARY POLICY FROM 2008 TO 2015

On the 26 December 2015, the SAMA raised the interest rate on reverse repurchasing agreements among Saudi banks by 0.25% (to 0.50%) in response to the increasing interest rate in the US. The value of the riyal increased against international currencies other than the dollar, which reduced the costs of imports from the Euro zone, the UK, Japan and China, thus leading to lower prices for commodities at the local market. Furthermore, increasing the interest rate in Saudi Arabia could negatively affect the shares prices, whereas the effect on the bond markets would be positive (SAMA report: 2015).

An increase in the interest rate for loans between banks (SIBOR) would lower the GDP growth rate by 0.9% and result in a 0.017% decline in investments. Moreover, inflation and money supply would increase slightly, bank credit would be reduced by 0.02%, loans for construction would be reduced by 0.07%, loans for transport and communications would be reduced by 0.23%, loans for industry would be reduced by 0.075 and other loans would be reduced by 0.029% (Algahtan: 2015)

Concerning the impact of changing interest rates on the Saudi economy, Saudi banks benefit by an increase in the interest rate margin, an increase in banking commissions, and an increase in loan costs for companies. However, the capacity of Saudi loan payments will not be affected, and the impact of

raising the interest rate by 0.25% will not a great impact on bank liquidity or capital adequacy ratios. Moreover, raising the interest rate in the KSA will increase the price of bonds and lower the demand for both government and corporate bonds.

There were considerable fluctuations in the Saudi interest rates on the repos, reverse repos, SIBER and legal reserve ratios for the period 2007 to 2015 as banks' legal reserves range from 7% to 12%, the SIBER rates ranged from 1% to 5%, the repos rates ranged from 2% to 5.5%, the reversed repos ranged from 0.25% to 0.50 and foreign reserves ranged from SR 2.6 to 2.71 trillion, as presented in Table 4:

Table 4: Interest Rates in the KSA (1997-2015)

Year	Interest between (SIBOR)	rates banks	Repos Rates	Reverse Repos Rates	Legal Reserve Rates
1997-2000	5%		3.5%	1.5%	7%
2000-2003	4.75%-4%		3.25%-3.5%	1.5%	7%
2004-2007	2.50%		5.4%-5.5%	1.5%	7%- 9%
2008-2015	1.5%-1% ⁰		4.25%-2%	0.5% to 0.25%	10%-12%
2015	1%		2%	0.25% to 0.50%	7%

Source: Computations of the researcher based on the annual reports of the SAMA and the report of the Riyadh Centre for Information & Consulting Studies, 20 December 2015.

In sum, there are several potential results from raising the interest rate in the KSA in response to the increase in the interest rate on the US dollar (Najeep: 2015). These impacts include (1) a negative impact on oil price due to the reverse impact of raising the interest on the US dollar in the oil market; (2) a negative impact on prices in the Saudi stock market in the medium and long term; (3) an increase in prices of newly issued bonds in the KSA; (4) an increase in the cost of borrowing for Saudi companies; (5) a rise in the value of the Saudi riyal due to an increase in the Saudi interest rate and the pegging of the riyal to the US dollar; (6) the weakening of the competitiveness of Saudi exports due to the rise in value of the

riyal; (7) a decline in the prices of imports from the Euro Zone, the UK, Japan and China due to the increase in the exchange rate of the riyal with respect to the euro, sterling pound, yen and yewan; (8) a decline in the price of gold in the Saudi market; (9) an improved value of Saudi foreign reserves and other assets valued in US dollars.

Pegging the Saudi riyal to the American dollar has restricted the role of the interest rate as a tool of the monetary policy in the KSA for the last 30 years. However, pegging the riyal to the US\$ has helped to stabilize the riyal exchange rate at 3.75 per US\$. Hence, the role of the Saudi monetary policy in the economy is weak compared to the role of the fiscal policy, which plays a larger role in the economy.

The following measures are suggested by the researchers to minimize the negative impact of rising interest rates in the KSA: (1) issue more government and corporate bonds in the Saudi financial market; (2) diversify the economy away from its dependence on oil; (3) establish a sovereign Saudi fund for investments and offer a substantial return; (4) expand the technological and manufacturing industry; (5) ration government expenditures according to new priorities; (6) investment in the training of human resources; (6) invest in renewable energy; (7) peg the riyal to a basket of currencies.

Due to the dual banking system in Saudi Arabia, where traditional banks exist side-by-side with Islamic banks, the impact of raising interest rates in the KSA could increase profits for traditional banks, while the Islamic banks are not affected by increased interest rates because Islamic banks are prohibited by Sharia law to charge interest.

SECTION V: CONCLUSIONS AND POLICY IMPLICATIONS

The study aims to investigate the role of the interest rate in the Saudi monetary policy and its economic impact during the international financial crisis. The research methodology, which

is both descriptive and analytical, analyses the means, standard deviations and percentages of secondary data. The study concluded that changes in the interest rate by the Saudi Arabian Monetary Agency (SAMA) have had both positive and negative effects on the Saudi economy. On the one hand, a reduction in the interest rate resulted in a low cost of credit, improved the liquidity of banks, promoted the competitiveness of exports and increased access to credit for companies, particularly small and medium scale enterprises. On the other hand, Raising the interest rate in the KSA increased the cost of credit for companies, improved the profitability of banks and raised the exchange rate of the Saudi riyal.

The findings of this study also have policy implications. The role of the interest rate in the Saudi monetary policy is restricted by two factors, namely, the pegging of the SR with the US\$, which limits the role of the interest rate in the Saudi monetary policy, and the dual banking system where traditional banks are affected by changes in the interest rate, while Islamic banks are not affected by changes in the interest rate because interest is prohibited by Sharia law. To create a more independent Saudi monetary policy, one of the alternatives is to peg the SR to a basket of currencies.

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