INTERNATIONAL MONETARY FUND

Monetary Policy Transmission in Oman

OMAN

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SIP/2024/018

IMF Selected Issues Papers **are prepared by IMF staff as background documentation for periodic consultations with member countries.** It is based on the information available at the time it was completed on December 14, 2023. This paper is also published separately as IMF Country Report No 24/032.

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Monetary Policy Transmission in Oman
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ABSTRACT: Amid a pegged exchange rate to the US dollar and an open capital account, Oman's policy rates move closely with US monetary policy. In this analysis, we show empirically that transmission from policy rates into effective lending and deposit rates remains subdued in Oman, even compared to GCC peers that similarly face a high oil price environment with persistent excess liquidity in the banking system. A cap on personal loan rates and low exposure of banks to SMEs and riskier borrowers limit passthrough into effective lending rates and credit conditions. The note documents ongoing actions by Omani policymakers to strengthen transmission and provides further recommendations on liquidity management, reserve management, and relaxing the interest rate cap.

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SELECTED ISSUES PAPERS

Monetary Policy Transmission in Oman

Oman

1. **Since the beginning of the current Fed tightening cycle in March 2022, the CBO has followed Fed policy rate hikes closely to maintain the OMR-USD peg.** Despite a 550 basis points increase in policy rates, interest rate passthrough in Oman has been weak and credit continues to grow under the impulse of strong private sector demand. This note documents the extent of monetary policy passthrough in Oman over the past 2 years, identifies reasons for weak passthrough, and provides policy recommendations to strengthen monetary policy transmission.

2. **Despite rising policy rates, interest rate passthrough in Oman has been weak compared to GCC peers and financial conditions have not tightened since January 2022.** Oman has closely followed the rate hikes by the Fed (Figure 1.1), like GCC peers, in order to maintain its peg. However, the passthrough from higher policy rates into deposit and lending rates has been weak in Oman compared to Saudi Arabia and the United Arab Emirates (Figures 1.4 and 1.5). While deposit and lending rates in Oman were almost flat year-on-year at the end of 2022, deposit rates rose by about 55 basis points over the past year in both Saudi Arabia and the United Arab Emirates and lending rates rose by 65 and 90 basis points, respectively.[1] Consequently, financial conditions in Oman have not tightened since the beginning of the Fed tightening cycle in 2022 (Figure 1.6) but have somewhat eased on the back of accelerating credit growth and lower external spreads.[2] Moreover, the divergence in passthrough from policy rates into effective interest rates relative to peers cannot readily be explained by the share of unremunerated deposits (Figure 1.2) or excess liquidity (Figure 1.3) alone. Along those characteristics, Oman ranks similarly to other GCC economies.

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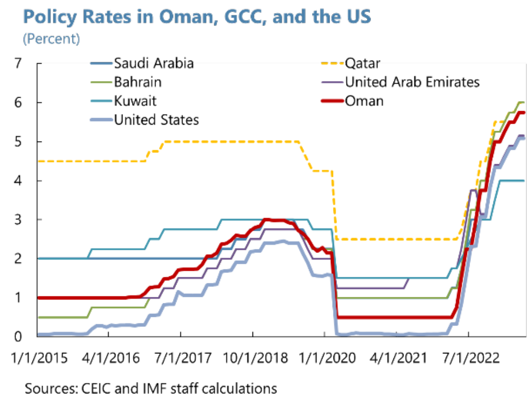
[1] While foreign-currency lending rates have increased in Oman, FX lending only accounts for about 15 percent of all loans. In the subsequent analysis, the focus is on the overall effective lending rate including both domestic currency and foreign currency loans. The overall effective lending rate has not increased since the beginning of the Fed tightening cycle.

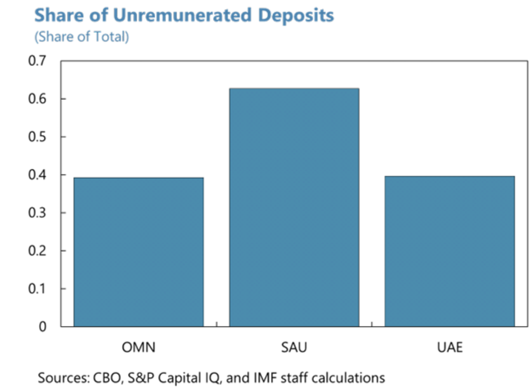
[2] The financial conditions index is computed as the first principal component of several financial market time series for Oman, including deposit rates, lending rates, credit growth, sovereign spreads and the VIX. Concurrent analysis has shown that results are qualitatively similar when using the method by Koop and Korobilis (2014), which ensures that financial conditions are identified separately from broader macroeconomic conditions.

Figure 1. Interest Rates

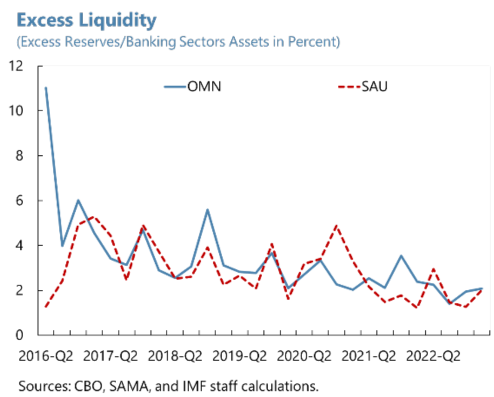
Though Oman has continued to closely follow the Fed …



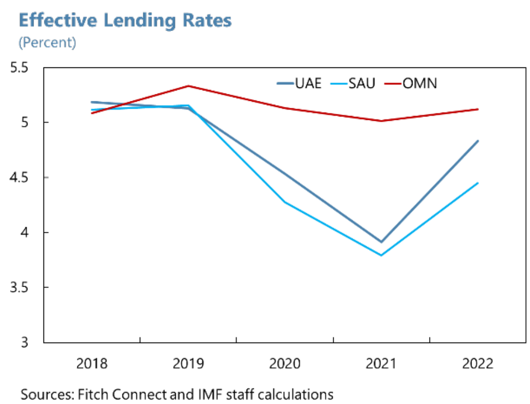
… and displays similar characteristics ….



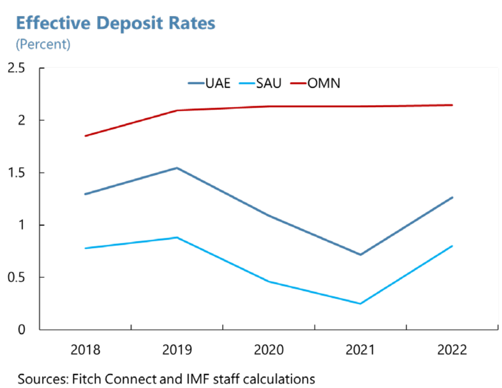
… as other banking systems in the region …



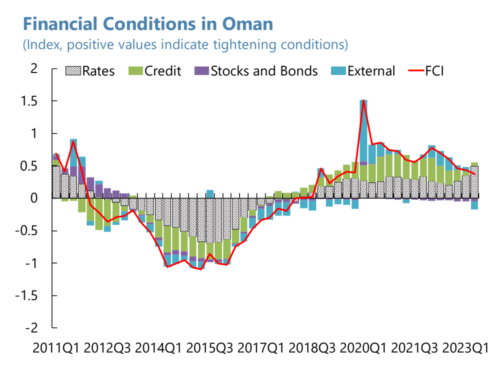
… passthrough into lending rates ….



… and into deposit rates has been very subdued …



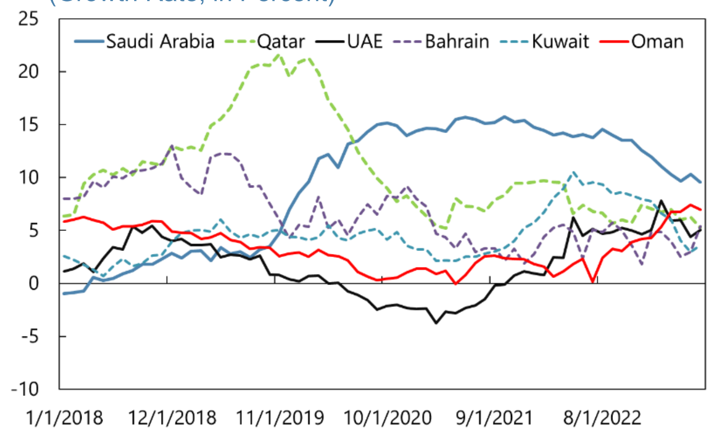
…. while financial conditions have eased since early 2022.



Sources: CEIC, Fitch Connect, CBO, Capital IQ, Haver Analytics, SAMA, and IMF staff calculations.

3. Econometric evidence confirms that passthrough into loan and deposit rates is significantly higher in other GCC countries. Using a regression model for the passthrough from US monetary policy tightening to domestic lending and deposit rates, Table 1 shows that for other GCC countries excluding Oman, a 100 bps Fed tightening correlates with a 34 bps increase in deposit rates and a 43 bps increase in lending rates after one year.[3] In Oman, however, there is no statistically significant increase in deposit rates and the impact on lending rates is half as large as in other GCC countries despite similar monetary frameworks (peg to USD)[4] and monetary policy transmission challenges (e.g., structural excess liquidity amidst high oil prices and a high share of unremunerated deposits).

Figure 2. Private Sector Credit Growth in the GCC
(Growth Rate, in Percent)



Sources: Haver Analytics and IMF staff calculations

Table 1. Oman: Monetary Policy Passthrough Regressions - Prices

	(1) Δ Effective Deposit Rate Oman	(2) Δ Effective Deposit Rate Other GCC	(3) Δ Effective Loan Rate Oman	(4) Δ Effective Loan Rate Other GCC
Δ Fed Funds Rate	0.048	0.341***	.226**	0.431***
	(.044)	(.069)	(.083)	(.118)
Δ Oil Price	-0.004	-0.006**	-0.011	-0.011***
	(.003)	(.002)	(.006)	(.002)
VIX	-0.015	0.01	0.02	.038
	(.009)	(.008)	(.019)	(.014)
Bank FE	x	x	x	x
Constant	.267	-0.256*	-0.48	-.855
	(.173)	(.142)	(.375)	(.285)
Observations	105	803	105	982
R-squared	0.098	0.272	0.18	0.06

Note: * indicates significance at the 10 percent level, ** indicates significance at the 5 percent level, *** indicates signifiance at the 1 percent level

4. Amidst weak passthrough to lending rates, private sector credit displays sustained growth since early 2022 in Oman and is now the second highest in the GCC. Private sector credit growth stands at about 7 percent (y-o-y) by end of 2023H1 driven by strong growth in both personal loans and corporate loans. While credit growth has slowed to an extent in many GCC countries since the beginning of the current Fed

[3] This magnitude is comparable to estimates reported in IMF (2022).

[4] The Kuwaiti Dinar is pegged to an undisclosed basket of currencies but co-movement of the Kuwaiti policy rate with the US policy rate is evident in Figure 1.

tightening cycle (e.g., Kuwait, Saudi Arabia), private sector credit growth has accelerated in Oman over the past 18 months, mirroring the weak passthrough of higher US rates into domestic lending conditions. Econometric estimates (Table 2) confirm that passthrough from higher policy rates into credit quantities in Oman is statistically indistinguishable from zero, implying that higher policy rates are on average not affecting credit growth. While nominal credit growth in other GCC countries is also not significantly affected by higher US rates (though the sign is negative), real credit contracts by 3.7 percentage points in response to 100 bps higher US rates.

5. **Amid persistent excess liquidity and limited interbank market activity, effective lending rates on OMR loans have slightly fallen since the beginning of the Fed tightening cycle**. Weak monetary passthrough extends beyond the personal loans segment (40 percent of the market), which is subject to the 6 percent interest rate cap. Effectively, the entire passthrough of higher policy rates into lending rates in Oman is driven by FX lending that accounts for one-eighth of the market, as domestic currency lending rates have marginally declined. While high oil prices dampen monetary passthrough in oil-exporting countries (IMF, 2022), excess liquidity has been a pervasive feature of the Omani banking sector including during times of low oil prices (Figure 3, Panel 1).

Table 2. Oman: Monetary Policy Passthrough Regressions – Credit

	(1) Δ Nominal Credit Oman	(2) Δ Nominal Credit Other GCC	(3) Δ Real Credit Oman	(4) Δ Real Credit Other GCC
Δ Fed Funds Rate	0.001	-.007	.025	-.037**
	(0.012)	(.008)	.026)	(.013)
Δ Oil Price	-.000	-.000	-.001**	-.000
	(.001)	(.000)	(.000)	(.000)
VIX	-.001	-.002	.003	-.005**
	(.002)	(.001)	(.004)	(.002)
Bank FE	x	x	x	x
Constant	.097*	.104***	.026	.142***
	(.046)	(.031)	(.069)	(.036)
Observations	86	881	79	788
R-squared	.262	.317	.268	.311

Policy Recommendations

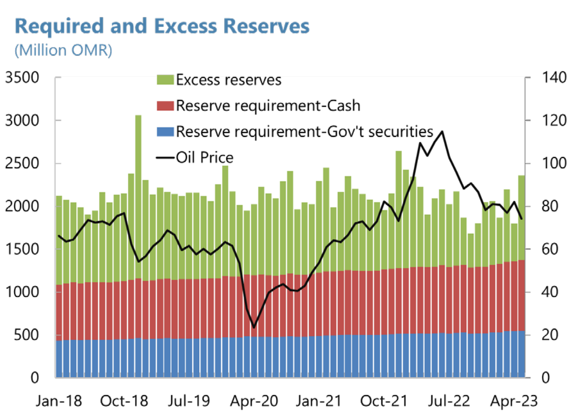
6. The authorities need to continue ongoing efforts to enhance liquidity management and improve monetary policy under the Monetary Policy Enhancement Project (MPEP). Building on better liquidity forecasting, the CBO toolkit to absorb excess liquidity needs to be expanded, including by preparing the resumption of issuance of certificates of deposit which have not been used since 2015 and the introduction of further liquidity instruments for Islamic banks. Modifying the reserve maintenance period for required reserves to begin on a weekday will facilitate better liquidity management and pave the way towards conducting open market operations. In addition, the current regulation that the reserve requirement can partially be met with sovereign bond (up to 2 percent) should be removed. Reducing the number of reserve eligible assets would contribute towards tightening liquidity. Ongoing efforts to put in place a full liquidity management framework should be continued, starting with the planned testing of a Call Money Market and Deposit Facility. Setting the stage for the conduct of open market operations can further support effective liquidity allocation while encouraging interbank market activity.

7. Further measures to strengthen passthrough include relaxing the interest rate cap and maintaining healthy banking competition. Relaxing the interest rate cap on personal loans would ensure banks can adequately reflect related credit risk and maintain margins. Amid ongoing banking sector consolidation, it remains crucial to maintain competition in the banking sector, which will further support increased interest rate passthrough and access to credit for riskier borrowers, including SMEs.

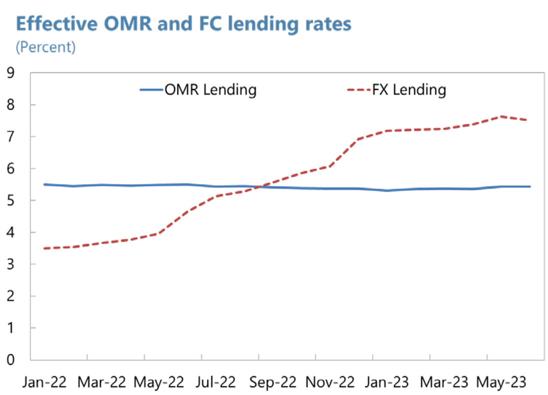
Figure 3. Excess Liquidity and Effective Lending Rates

Amidst persistent excess liquidity ….

… higher policy rates have not passed through into lending rates.



Sources: CBO and IMF staff calculations



Sources: Haver Analytics and IMF staff calculations

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