Capital flows and financial assets in emerging markets: determinants, consequences and challenges for central banks

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General comments

Cross-border capital flows have increased very rapidly this decade due to liberalisation of financial markets and information technology. This expansion has been accompanied by broad-based global growth and has resulted in diversification of investments and, in emerging market economies (EMEs), financial market development and a reduction in the cost of capital. It was inevitable, however, that capital inflows would complicate the conduct of monetary policy. In particular, certain developing Asian economies (eg China and India) have received inflows which have raised the challenge of investing those inflows while managing upward pressure on exchange rates.

Broadly speaking, central banks faced with large capital inflows can choose between three responses in a global environment which is becoming inflationary (due to rises in prices of food and raw materials). The first is to let the currency appreciate. This reduces inflationary pressure but makes domestic industry less competitive and introduces instability into the exchange rate (what goes up may come down). The second is to sterilise the inflows in some way: a recent development has been the establishment of sovereign wealth funds that recycle capital surpluses abroad. The third possible response is to undertake administrative measures such as raising reserve requirements and restraining credit expansion to limit the impact of capital flows, in particular on inflation.

Because global capital flows are intermediated through financial markets, central banks will have to pay even closer attention to the developments in their domestic markets to make sure that they understand where leverage and excessive risk-taking activity is occurring. It was noteworthy that at the start of the recent global credit crunch, the major central banks were challenged by the multiple roles played by commercial banks in the creation, packaging, selling, financing and ownership of credit derivative products. An issue of interest is how central banks can work to anticipate similar events in the EMEs.

Prior to the meeting, the BIS circulated a detailed list of questions for participants, grouped under the six headings shown below. Saudi Arabia’s situation is unusual in that it has historically had an open capital account with substantial build-up of both private and public assets abroad. Inward investment has mainly been in large joint ventures. Domestic asset markets are not characterised by sophisticated use of derivatives and there is little evidence of hedge fund activity. The questions are designed for more diversified economies where private sector capital inflows are dominant. Thus, many of these questions are peripheral to the concerns of the Saudi Arabian Monetary Agency (SAMA).

1. The size and composition of gross capital inflows and their risk characteristics for the receiving EMEs

In Saudi Arabia, gross capital inflows are dominated by oil revenue which flows to the account of the government, and for which SAMA has complete information. Second, there are investment inflows, particularly for joint ventures to develop the economy, normally financed by syndicated loans which are monitored. Third, there are private investment flows into asset markets. Foreign investors are not allowed to invest directly in the Saudi stock market, but they can invest through mutual funds. The private sector has substantial overseas assets and, when repatriated from time to time, these show up as capital inflows. Foreign direct investment (FDI) is encouraged by the authorities and has picked up significantly since Saudi Arabia's accession to the World Trade Organization (WTO) at the end of 2005. According to the Saudi Arabian General Investment Authority (SAGIA), the value of gross FDI in Saudi Arabia rose to $18 billion in 2006 from $12 billion in 2005, and the total stock of FDI was about $48 billion in 2006.

2. The size and composition of capital outflows, with particular emphasis on financial asset investment abroad intermediated by financial institutions

As with capital inflows, there are no restrictions on capital outflows. Government organisations are major investors abroad. These include the Public Pension Agency (PPA), the General Organization for Social Insurance (GOSI), the Saudi Fund for Development (SFD) and also SAMA, which manages the foreign exchange reserves. There is no specific sovereign wealth fund or stabilisation fund. Private sector assets abroad are estimated to be sizeable. Historically, domestic banks have arbitraged between US dollar and Saudi riyal rates, placing funds in the interbank markets to take advantage of interest rate differentials and relying on the fixed exchange rate regime. Recently the trend has been to manage assets as investment portfolios rather than liquidity management.

The government has been encouraging financial market development. Under the Capital Markets Authority (CMA), additional investment banks/brokers have been licensed and there is a growing private sector pension and insurance business, a large part of which is likely to go abroad in the form of long-term investments.

3a. Implications for the depth of the financial sector and its resilience

Because gross capital inflows are dominated by the government account and the funds flow into SAMA, capital inflows have not been an important influence in restructuring the local asset markets. The Saudi stock market is one of the most liquid in the region. The government bond market is illiquid due to the paying-down of government debt (debt/GDP is poised to fall from its peak of around 100% to about 19%). The real estate market is dominated by Saudi citizens. Domestic asset prices have not been seriously impacted by the recent global credit crunch.

3b. Consequences of inflows for domestic asset markets and non-financial corporate balance sheets

Foreign investment has become important in the last few years in the specific context of large joint venture development projects financed by syndicated loans (and on occasion by tightly distributed bond issues). Foreign demand has little impact on the level of asset prices and there is no evidence of sizeable hedge fund activity. Derivative markets are still in their infancy.

4. Implications of capital flows for the conduct of monetary policy: exchange rate developments; sterilisation; control over interest rates

Operationally, SAMA's routine sales of dollars to domestic banks are aimed at meeting the private sector's commercial and financial demand for foreign currencies. Under normal circumstances, foreign exchange operations have no discernible effect on money market conditions. In the event of excessive foreign exchange outflow or inflows for speculative or event-specific reasons, there tends to be an imbalance in system liquidity, causing interbank riyal interest rates to rise or fall. However, the application of liquidity instruments, such as repos and foreign exchange swaps, has been instrumental in addressing money market disequilibrium to a large extent.

The driver of monetary developments over the last few years has been oil revenue. Economic activity remains vigorous. The rate of nominal growth cooled somewhat in 2007 due to developments in the oil sector (lower oil production). The non-oil economy will continue to provide the main engine of economic growth but depends on the continued flow of oil income to a large extent. In 2007, nominal GDP growth was 7.1%, real GDP growth 3.5%, the current account surplus stood at about $92 billion, and inflation averaged 3.7% for the first 10 months of the year.

Inflows from expanded oil revenue have allowed the government to increase fiscal spending and simultaneously pay down debt. This has stimulated the economy and enhanced the liquidity of the banking system. As the government has pursued a policy of paying down government debt, domestic banks have become forced dissavers of government securities, and have responded by increasing their consumer lending activity. M3 has been growing at around 20% per annum.

There has been some debate about the merits of retaining a base public debt/GDP ratio, which might be around 20%. This could provide a benchmark yield curve for corporate debt and would allow the issuance of longer-dated instruments. But so far the paying-down of debt has meant that in effect there is no sterilisation policy: in practical terms oil revenue dollars flow into SAMA's account and are reinvested abroad in a prudent diversification of assets. More problematic is the effect on the economy of higher fiscal spending, which has exacerbated the inflationary situation.

In late 2004, SAMA began to tighten the repo and reverse repo rate. In 2005, SAMA supplemented a tighter monetary policy by introducing administrative measures to limit rapid growth in consumer and stock market margin loans. When the stock market corrected precipitously in early 2006, SAMA's priority was to avoid exacerbating financial market conditions by delaying further withdrawal of policy stimulus. As the stock market showed signs of stabilisation, SAMA increased policy rates in February 2007 as part of its tightening campaign against rising M3 growth and inflation. More recently, SAMA has continued the downward adjustment to its reverse repo rate without altering the benchmark repo rate in view of speculative buying of the riyal and the Federal Reserve's policy easing in the aftermath of the subprime mortgage lending crisis.

Currently, high levels of liquidity in the economy and continuing expectation of a realignment of the riyal mean that SAMA has limited traction in controlling liquidity by adjustment of repo and reverse repo rates. Inflation is becoming a matter of concern. This is a largely home-grown issue, due to higher rental/real estate prices, wage inflation and higher food prices globally. Restraining the growth in government spending is important to tackling inflation. The government has recently introduced a subsidy on rice and baby milk.

5. Regulatory and supervisory response to financial stability challenges posed by capital inflows

Saudi Arabia has followed a path of open capital flows. The authorities closely monitor commercial banks' activity to make sure that they follow a prudent pattern of behaviour with regard to their foreign exchange positions.

Conclusion

In conclusion, the global liquidity glut will continue to present challenges for central banks in steering their monetary policy. The interplay between financial stability and monetary policy is a relatively new field of research which is continuously evolving. There is no simple answer to the question of how much emphasis the central bank should place on financial stability considerations in its monetary policy. Domestic social and regulatory conditions can have an important influence on all aspects of macroeconomic policy.

As is the case with most central banks in the developing economies, SAMA is faced with the challenges of abundant domestic liquidity, surging M3 and rising inflation. Given the limited effectiveness of interest rate moves, as part of its monetary management SAMA has recently resorted to raising reserve requirements following the introduction of prudential guidelines on credit expansion in 2005. Fiscal policy remains the key to restraining growth in M3.