Monetary policy in Saudi Arabia

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1. Introduction

In Saudi Arabia, the exchange rate anchor provides the long-term framework for monetary policy. Within that framework, there is some flexibility to alter domestic monetary conditions. This can be done by changing policy interest rates (repo rates), introducing prudential guidelines on bank lending, and adjusting reserve requirements. The Saudi Arabian Monetary Agency (SAMA) is vested with the conduct of monetary policy and has instrument and operational independence in pursuing its policy objectives.

2. Policy objectives

As set out in SAMA's Charter (Article 1), SAMA's mandate includes:

i. issuing and strengthening the Saudi riyal and stabilising its internal and external value;

ii. dealing with the banking affairs of the government; and

iii. regulating commercial banks and exchange dealers.

Also, as per the Cooperative Insurance Law promulgated in 2003, SAMA has been mandated to regulate and supervise insurance companies.

3. Policy choice

Saudi Arabia's policy choice is exchange rate targeting, for the following reasons:

- It is a resource-based economy with foreign exchange receipts and payments predominantly in US dollars.
- USD/SAR exchange rate stability is critical to encouraging investments in Saudi Arabia in order to diversify the economy and state budget planning.
- As the export sector is dominated by oil and petrochemicals, changes in the USD/SAR rate per se do not meaningfully contribute to Saudi Arabia's terms of trade.

Exchange rate targeting is the principal monetary policy objective, complemented by an operational focus on system liquidity and the medium-term goal of maintaining price and financial stability.

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4. Exchange rate management

Saudi Arabia pursues a policy of linking the riyal to the US dollar, which reflects the country's revenue and expenditure pattern and the role of the dollar in international financial markets. As for SAMA's exchange rate management, a brief historical background will be helpful.

Saudi Arabia has been through numerous negative and positive terms of trade shocks, but since 1986 the exchange rate parity has been fixed at SAR 3.75 per US dollar and a countercyclical fiscal policy has been used to stabilise the growth path. The government runs a fiscal surplus when oil exports are strong and the economy is in external surplus. When oil exports weaken, foreign exchange assets are run down and the government boosts domestic demand by deficit spending. The official position aims at long-run stability rather than short-run solutions.

In the 1990s, the riyal came under selling pressure on two occasions (in 1993 and 1998) due to contagion from falling oil prices and the Asian financial crisis. SAMA managed to smooth out the pressure through intervention in the forward market, which is often used by speculators and market operators for operational convenience.

5. Inflation

Housing and food prices have been the drivers of inflation in Saudi Arabia (particularly in 2007 and 2008). Rents were driven up by demographic pressure and supply bottlenecks. Food prices rose because of droughts and the increase in domestic demand in the commodity-exporting countries. When inflation is due to supply side factors such as these, exchange rate moves and monetary policy are less effective in containing it. There was some public pressure during 2007 and 2008 to revalue the riyal to mitigate the impact of inflation on consumers. In fact, revaluation would have accentuated the inflationary boom of the upswing by increasing consumer purchasing power at a time when demand was already strong on the back of relatively high oil prices. Similarly, a devaluation in a downswing would take purchasing power out of the economy by hiking import prices at just the moment when domestic demand was falling.

In Saudi Arabia, supply side inflation is better handled by addressing the bottlenecks (as was done in the 1970s with housing problems and the crowding of ships at ports) and through subsidies on essential items. To the extent that inflation is a monetary phenomenon due to bank credit expansion, prudential monetary measures work well (Saudi Arabia's policy stance before the global credit crisis included higher reserve requirements and prudential guidelines on bank credit as well as fiscal restraint). Some commentators argued that high real interest rates would have curbed inflation but this argument does not hold in Saudi Arabia, where consumers are not heavily borrowed and the ratio of bank credit to GDP is modest at around 50% (average for 2008 and 2009).

Inflation targeting is not an option for Saudi Arabia due to its fixed exchange rate regime. Inflation targeting is arguably not practical in most emerging economies, which are faced with volatile capital flows. Given the fiscal dominance in Saudi Arabia, and for that matter in emerging economies generally, monetary policy can at best complement fiscal policy in maintaining price stability. From the mid-1980s to the mid-2000s, inflation was low and stable, averaging about 1% annually. After 2006, inflation began to pick up, reflecting robust domestic demand and rising food and rental prices, and it peaked at 11.1% in July 2008. Currently, inflation is 5.8% (as at October 2010, on a year-on-year basis).

6. Macroprudential measures

Monetary policy cannot be effective if the banking system is weak. Policies to pursue financial stability are just as important as targeting the exchange rate or inflation. In Saudi Arabia, bank supervision and monetary policy are both carried out by SAMA, and this arrangement has served the economy well. SAMA has always been proactive in ensuring financial stability by introducing prudential guidelines and tightening credit criteria at a time when credit was easily accessible globally. Despite criticism of its conservatism, SAMA continues to encourage banks to maintain a capital cushion far in excess of the required minimum capital adequacy (at the end of Q2 2010, the average capital adequacy of the banking system in Saudi Arabia stood at 16.8%). SAMA also prescribes a prudential liquidity ratio in the form of liquid assets at no less than 20% of bank deposits, a loan/deposit ceiling guideline at 85% and dynamic provisioning so that the system stays resilient in any crisis. This discipline has provided Saudi Arabian banks with sufficient buffers to safeguard the interest of depositors and shareholders, and to support the economy.

7. Asset prices

An important lesson learnt from the recent global credit crisis is that asset price inflation and bubbles cannot be ignored by central banks. The consequences of not acting when asset prices appear to rise unsustainably can be extremely serious, affecting the entire financial system (systemic risk). The crisis has led to a diagnosis that would have previously been unacceptable:

- Central banks should “lean against the wind” by using monetary policy to dampen unjustifiable rises in asset prices even when there is no immediate risk of inflation.
- The root cause of crises is weak supervision of financial institutions and markets, and this warrants replacing “light touch” regulation with sound regulation and supervision of all financial institutions.
- Individual bank regulation must be complemented by an overview of financial stability.

8. Conclusion

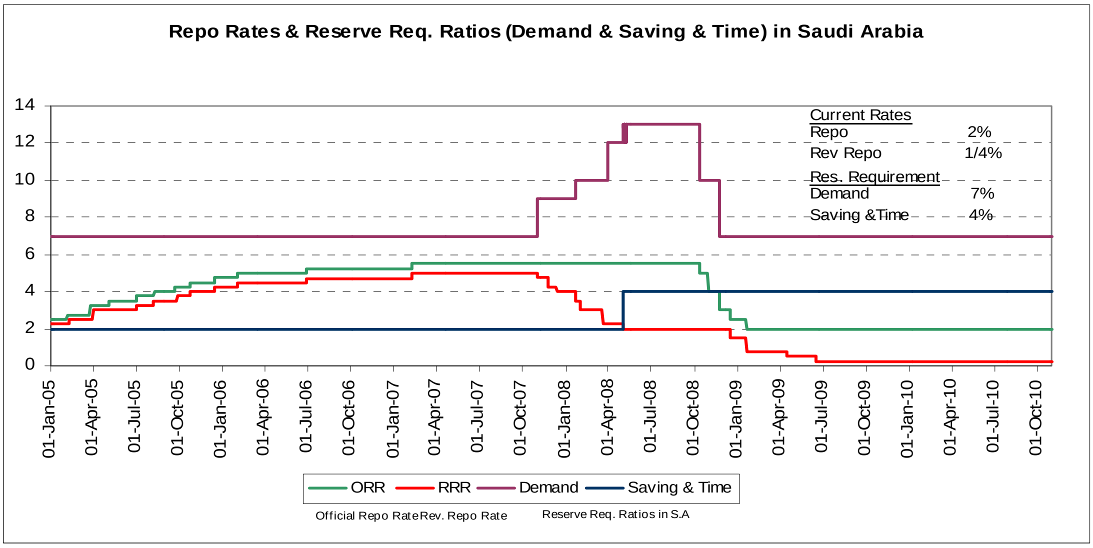
Price stability warrants continuous monitoring and appropriate policy responses to contain inflationary pressures in an economy where interest rate signals are less effective. Low and stable inflation will allow higher growth on a sustained basis in an environment of overall stability. Saudi Arabia takes a long-term view that looks through the cycles in the oil market. Both fiscal and monetary policy are used to dampen the effect of oil price volatility on domestic economic development (ie adjusting the level of foreign exchange reserves and retiring domestic debt in good times should help insulate the economy from oil price swings). For a volatile resource-based economy, such as Saudi Arabia, countercyclical fiscal policy and the fixed currency parity are more appropriate for containing output shocks than using the exchange rate route. As financial stability is key to effective monetary policy transmission, SAMA takes a proactive role in supervising banks through risk-based as well as macroprudential approaches.

Table 1

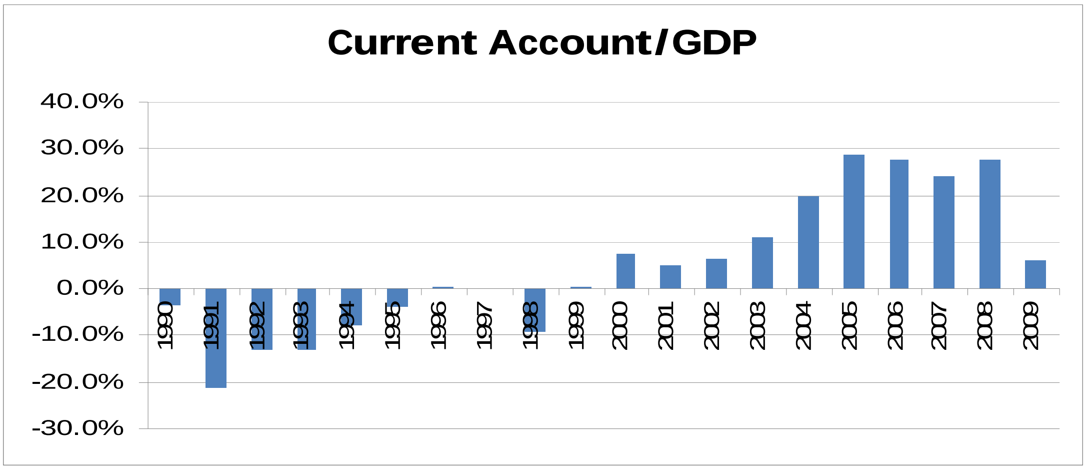
Saudi Arabia – key indicators

	2000	2009	Remarks
Government			
Fiscal balance/GDP	3.2%	–6.2%	Deficit in 2009 after showing surplus in the last six years, with 32.5% surplus in 2008
Govt. debt/GDP	87.2%	16.0%	Improved significantly due to accelerated govt. debt redemption and higher nominal GDP growth
Current account balance/GDP	7.6%	6.1%	CA balance is a function of volatile oil revenues
Banking sector			
Capital adequacy (Tier I & II)	21.0%	16.5%	Far in excess of the Basel III minimum requirement
Loan/deposit (private sector)	62.0%	77.8%	Reflecting the pace of domestic demand, but well below 100%
Bank credit/GDP (private sector)	24.6%	52.3%	Steadily increasing as banks are extending consumer loans
Assets/equity (leverage)	10.0x	7.2x	Significantly lower than the industry norm
Bank assets/nominal GDP	65%	99%	Developing financial depth
Household sector			
Consumer debt/GDP	3.9%	13.5%	Consumer debt/GDP is far below the level in emerging economies (Asia ex-Japan is about 26%)

Graph 1



Graph 2



Graph 3