Globalisation, financial markets and the operation of monetary policy: the experience of Saudi Arabia

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1. Overview

The essence of globalisation is the integration of markets worldwide and the deepening of various interdependent relations. Financial globalisation (cross-border capital flows) and financial integration (capital market linkages) are closely related. Countries in the early stages of financial integration have been exposed to significant risks in terms of higher volatility of both output and consumption.

Financial globalisation since the mid-1980s has been marked by a surge in capital flows between industrial and developing countries. Although capital inflows have been associated with high growth rates in some developing countries, a number of them have also experienced periodic collapses in growth rates and significant financial crises. An overvalued exchange rate and a domestic lending boom in which financial institutions become overextended often precede a currency crisis. The ability of a developing country to derive benefits from financial globalisation and its vulnerability to the volatility of international capital flows can be significantly affected by the quality of both its macroeconomic framework and its institutions.

International financial integration helps promote domestic financial sector development, largely in industrial countries. The proliferation of financial and currency crises among developing economies is often viewed as a natural consequence of the "growing pains" associated with financial globalisation.

2. SAMA's experience in a globalised environment

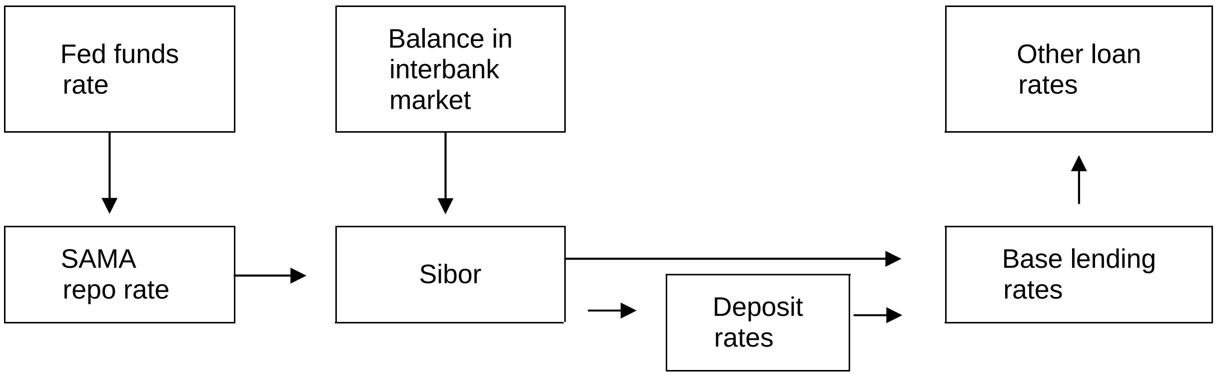
2.1 Financial integration (capital flows and markets)

Saudi Arabia has been much less affected by external shocks and market volatility than have other emerging markets. This is because our policy preference has been to attract foreign direct investment, which serves both the investor and the domestic economy through joint ventures and transfer of technology. Saudi Arabia is gradually opening up its financial markets for portfolio investments. There are no restrictions on foreigners with regard to investing in government bonds but the stock market is not yet fully deregulated. Foreign investors can, however, invest in the stock market through open-end funds. The present regulatory structure of the market has shielded the country from disruptive capital flows. Furthermore, the domestic banks are net suppliers of funds in the interbank market, and the country as a whole is a net capital exporter. Corporate borrowing needs are largely met from domestic sources. Against this background, the question of "sudden stops in capital flows" is not relevant to Saudi Arabia.

With regard to the functioning of financial markets, the Saudi Arabian Monetary Authority (SAMA) believes in the free workings of the markets. There is no formal interest rate structure in Saudi Arabia. Policy operates by affecting the level of interbank liquidity through the repo window and thereby influencing the interest rate in the short-term professional money market. Capital expenditure and corporate borrowing for investment respond to banks' commercial lending rates.

Interest rates in Saudi Arabia are influenced by two factors. First, Saudi Arabia is an open economy, with no restrictions on currency convertibility. The cross-border movement of funds responds to the differential between domestic and foreign returns. Second, the country has a pegged exchange rate system. Since June 1986, monetary policy has been directed towards keeping the exchange rate at USD 1 = SAR 3.75. The fixed exchange rate regime implies that Saudi Arabia's financial market is highly integrated with external financial markets, and in particular the US market. In the domestic market, the arbitrage mechanism makes US interest rates the dominant factor in determining riyal interest rates. From time to time other factors have also been important, such as when large amounts of funds have been placed during share market flotations (eg in the early 1990s, when some banks floated shares to take advantage of the stock market's star performance, and recently in late 2002, when Saudi Telecom Co (STC) was 30% privatised). In short, given the open capital account and the credible fixed exchange rate system, the supply of funds in the interbank market is highly interest rate elastic. Any significant difference between domestic and comparable US interest rates tends to spur a cross-border movement in funds (swift asset substitution for incremental returns). At times the exchange rate link means riyal rates are at odds with domestic macroeconomic considerations (ie higher rates incompatible with subdued economic conditions).

Interrelationship of various interest rates



In Saudi Arabia, bank intermediation still dominates in channelling funds to various sectors of the economy because the bond market is still in the development stage and the equity market has overly conservative listing requirements. This will change following the recent enactment of the Capital Market Law and the formation of a Stock Exchange Commission.

2.2 Monetary policy (independence and operations)

Most central banks define independence as the capacity to set instruments and operating procedures (so-called instrument independence). By contrast, goal independence tends to be important to central banks in particular circumstances. Based on the above characterisation, SAMA is an independent central bank in its own right. Its immediate policy focus is to manage system liquidity on a day-to-day basis in a bid to contain wild fluctuations in money market rates and disruption to the smooth functioning of the interbank market. SAMA's intermediate target is exchange rate stability and the ultimate goal is price/financial stability. In fact, exchange rate targeting makes monetary policy less independent, and this is more pronounced in fixed exchange rate regimes. Lower riyal rates often trigger foreign exchange outflows due to interest rate arbitrage. On the basis of cost/benefit analysis, it is deemed appropriate to let riyal rates carry a small premium over dollar rates. In a global context, monetary policy is becoming more synchronised due to greater financial integration. Policy trends are clearly converging, with differences in the degree of accommodation. It may be noted that SAMA's conduct of monetary policy is not dominated by fiscal exigencies. SAMA does not seek to influence the yield curve to accommodate the government's cost of financing deficit, nor does it coerce banks into financing the budget deficit.

In our experience, higher foreign exchange reserves serve as a credible cushion for conducting monetary policy more flexibly. During the rudimentary stages of financial market development in the late 1970s and early 1980s, riyal rates were often posted below comparable dollar rates, mainly due to higher oil revenues, foreign reserve accumulation and government spending. As fiscal operations have significant influence on generating domestic liquidity and money supply, the riyal market remained overwhelmed with liquidity. However, the domestic banks' excess riyal liquidity management through foreign exchange swaps (ie lending riyals through the swap mechanism) yielded wild swings in the short-dated market. In order to mitigate the impact of the persistent liquidity stream and its attendant effect on the banks' balance sheets, the government ruled that contracts in excess of SAR 300 million would be denominated and paid in dollars.

SAMA introduced money market reforms in the early 1980s. It started offering Bankers' Security Deposit Accounts (BSDAs) in 1984 to better manage system liquidity. Subsequently, there was a noticeable improvement in liquidity management and predictability of short-dated rates. BSDAs were replaced with treasury bills in 1992. The 1990s witnessed a better structured domestic money market due to the expanded role of repos in managing system liquidity. In a narrow sense, SAMA's open market operations are restricted to day-to-day repo activity.

SAMA's intervention in the foreign exchange market can be described as both passive and active. As the government is the main earner of foreign exchange from oil exports, the private sector depends on the government to meet its foreign exchange requirements. SAMA, as the government's banker, sells dollars to domestic banks regularly (passive intervention). This is the underlying reason why the spot riyal trades around the official exchange rate of SAR 3.75 per US dollar. In times of uncertainty and speculative bouts against the riyal linked to soft oil revenues, forward foreign exchange prices are affected, as it is operationally convenient for market operators to trade through the forward market. Under extreme circumstances (1993 and 1998), SAMA has intervened in the forward foreign exchange market in modest amounts with a noticeable impact on forward prices. The timing and size of this intervention was linked to the cost of running short riyal positions and the post-intervention pace of changes in forward prices. Occasionally, SAMA has resorted to foreign exchange swaps to inject riyal liquidity to stabilise the money market.

2.3 Central banks and financial stability

The 1997-98 Asian financial crisis provided a stark demonstration of the destructive effects of financial instability. Price stability is certainly not a sufficient condition for financial stability. Banking problems of the 1990s warrant that, in the long run, financial and monetary stability should mutually reinforce each other. But, in the short run, easing monetary conditions may be an entirely appropriate response by central banks concerned about financial fragility spilling over into system-wide problems. The LTCM example, when the Federal Reserve eased monetary conditions to increase liquidity in the financial markets, is a case in point.

SAMA has long had a keen interest in financial stability. It acted as a source of emergency liquidity assistance (through soft deposit placements) to some of the banks facing acute liquidity problems or potential insolvency in the 1980s. Critics may regard such assistance as a source of moral hazard, but in a broader context it becomes imperative to save the system from systemic risk. Banking business is all about public confidence, and once this is eroded it becomes too painful to restore it. From experience, it is better to nip the problem in the bud rather than let it develop to the point of frustration. The recent episode of the Y2K scare and central banks' willingness to inject massive liquidity into the banking system confirms the notion that financial stability remains the core concern of monetary authorities. In a globalised economy, financial stability has become a central bank objective, and in this context pre-emptive policy actions to address potential instabilities are justifiable. In many cases, the explicit references to financial stability fall within the realm of banking and the efficient operation of the payment system.

Central bankers, however, do not subscribe to the BIS suggestion of considering asset prices in conducting monetary policy. The BIS favours prudential policy action in market upturns as well as against negative shocks. Central bankers appear to be extremely cautious about asset prices because assessing valuation is a very challenging exercise. It is not the asset price per se which is hard to determine, but its deviation from a highly hypothetical fundamental value. Central bankers are, therefore, against using highly volatile indicators in the measurement of price stability or in the conduct of sound monetary policy. Based on this logic, central banks' response to asset prices would be asymmetric.

3. Conclusion

The net benefit of globalisation differs within and among countries, depending on the mix of macroeconomic policies and trade regimes pursued by policymakers. Information technology and greater financial integration are influencing the conduct and effectiveness of monetary policy. Central banks are doing away with their earlier policy of ambiguity in favour of better transparency. Globalisation of financial markets has broadened opportunities for accessing capital funds and investments. In the aftermath of the 1997-98 Asian financial crisis, it has become quite obvious that financial stability is key to conducting monetary policy and achieving its primary objective (price stability).

In today's globally integrated markets it is important for central banks and other financial authorities to share information and to communicate on crisis prevention measures. In this regard, the BIS has been instrumental in providing central banks with background research on various central banking and market-related issues for discussion in their routine meetings.