Monetary policy transmission mechanism in Saudi Arabia

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1. Introduction

In most emerging economies, the exchange rate still plays a greater role in the monetary transmission mechanism than interest rates. This is partly because domestic banking systems are less developed, and partly because a full range of monetary instruments is not available. The exchange rate is part of the transmission mechanism in two ways. First, it affects aggregate demand through net exports; and second, it affects inflation directly through the pass-through effect, although the pass-through is having less of an impact in a globalised economy, where competition is keeping prices well contained.

In recent years, monetary policy in Saudi Arabia has been influenced by abundant liquidity due to high oil prices, and by the growth in consumer and business lending by domestic banks. One major challenge has been how to respond to asset price inflation. A second challenge has been to develop Government bond markets to provide a wider range of assets to domestic banks so that the transmission mechanism from repo rates to the longer end of the bond and credit markets can be enhanced. Finally, Islamic financing has been growing in importance.

2. Structure of the policy framework

Saudi Arabia's monetary policy framework is firmly wedded to its fixed exchange rate policy. Saudi Arabia uses the exchange rate as a nominal anchor for stabilizing exchange rate expectations and keeping inflation low. This maintains public confidence in the policy framework and encourages capital inflows for domestic investment. The rationale for pegging the Riyal to the Dollar is the pattern of Saudi Arabia's external receipts and payments, which are predominantly in US Dollars. Saudi Arabia derives most of its revenue from oil exports, which vary widely and cannot be adjusted by changes in the exchange rate as they depend critically upon world energy demand. Therefore, the Government stabilizes the economy by operating a counter-cyclical fiscal policy in which expenditures are kept steady when receipts are volatile. Hence, the stability of the Riyal against the Dollar is relevant in the context of overall economic policy.

The operational target of the Saudi Arabian Monetary Authority (SAMA) is to manage system liquidity through the repo window, and its intermediate target is stability of the Riyal against the Dollar, which is the anchor and intervention currency.

3. Monetary policy rules and instruments

Monetary policy comprises policy targets (eg medium-term price stability or exchange rate stability); strategy (what interest rate level is required to achieve the target); the operational framework, which determines how to reach the required interest rate level by using the available instruments (eg key interest rates such as repo, supply of reserves); and the monetary policy transmission mechanism, which is the process through which monetary policy decisions affect the economy in general and the policy target in particular. Inflation-targeting rules, the exchange rate, monetary aggregates and the level of bank reserves are often used as part of the strategy process because they limit the discretion of the central bank, strengthen its credibility and anchor private sector expectations. Changes in rules are more important than any single change in policy instruments. Interest in monetary rules has increased over the past decade as many central banks sought to organize their policy deliberations around specific targets. In contrast, a feedback rule (such as Taylor's rule) does not give complete guidance on deviations between actual and target values of objective variables because of interpretation problems on relevant targets (ie the desired inflation, output, and equilibrium funds rates).

In Saudi Arabia, the exchange rate is targeted for conducting monetary policy. Although reserve requirements have been a powerful instrument of monetary policy in the past, SAMA has made no changes to reserve requirements since 1980. With the advent of Central Bank Bills in 1984, SAMA moved to using repo rates for managing day-to-day system liquidity and signaling the desired overnight rate to the market. Government Development Bonds inaugurated the government debt market in 1988, and the Central Bank Bills were replaced by Treasury Bills in 1992. Currently, the repo and reverse repo rates are the most effective indirect instruments used by SAMA for conducting monetary policy. Recent budget surpluses have allowed the payback of longer-dated Government debt, but SAMA makes sure that enough Treasury Bills remain in issue to allow repo operations to continue unhampered. In times of severe speculation against the Riyal through the forward market, SAMA augments its repo rate policy with intervention in the forward market to contain wild gyrations in foreign exchange (Fx) swap points and interest rates.

4. Monetary policy transmission

Emerging markets generally face a higher degree of uncertainty with regard to capital flows than is the case for industrial countries. Under a fixed exchange rate regime (or a fixed but adjustable peg) as in Saudi Arabia, capital inflows put downward pressure on domestic interest rates and increase investment relative to domestic saving. If inflation rises as a result of abundant liquidity, external competitiveness will deteriorate. Under a floating exchange rate regime, capital inflows lead the exchange rate to appreciate, resulting in a loss of competitiveness.

SAMA seeks to ensure that monetary and exchange rate policies are mutually consistent. Given the Riyal peg to the Dollar, short-term Riyal interest rates should in theory be almost identical with their Dollar equivalents. With almost perfect asset substitutability between Riyal and Dollar instruments, a small change in Riyal interest rates results in a large change in domestic liquidity. In times of speculation against the Riyal, SAMA initially lets the interest rate differential widen to make speculation more expensive. Fx intervention is a discretionary policy under extreme market conditions, and this option has proved to be effective in mitigating speculation-linked volatility in the forward market, which happens to be a preferred channel for speculation and interest rate play. On two occasions (ie 1993 and 1998), SAMA intervened in the forward market as interest rate support faltered in containing excessive volatility in Fx swap rates resulting from speculation against the Riyal.

When oil revenues are high, as is currently the case, the result is an injection of liquidity into the monetary system. This puts downward pressure on domestic interest rates and paves the way for asset price inflation. In recent times this effect has been exacerbated by private investors keeping extra funds in the domestic banking system instead of diversifying their portfolios through investment abroad. A further development has been in the banking system. Home ownership and mortgages have grown in importance, and the banks have increased their emphasis on making consumer loans. This exacerbated the inflation in share prices, as many participants were using borrowed funds. In a fixed exchange rate system, it was more appropriate to target this problem with administrative measures instead of a rise in interest rates through the repo rate channel. SAMA therefore curbed the abundant liquidity by setting prudential requirements for bank credit to the private sector as well as margin lending relative to total credit.

Monetary policy mainly influences short-term interest rates, which are used for pricing deposits and loans. Interest rate changes tend to induce portfolio shifts among assets that may, in turn, affect their relative prices. The interest rate channel affects asset prices. The recent liquidity boom in Saudi Arabia was the result of high oil revenues and a shift in investor preference towards domestic assets. These factors led to very low interest rates. An atmosphere of excitement about gains in the stock market took hold, with irrational expectations about the market trend. The result was a temporary "wealth effect", which was reflected in consumption and investment. In this context, should monetary policy react to asset prices? This issue is still debated among researchers and academics. SAMA's policy is to remain extremely cautious on targeting asset prices. This is because assessing asset price valuations is a very challenging exercise. Indeed, tightening guidelines on bank credit and margin lending was not an attempt to influence asset prices directly. In the aftermath of a precipitous decline in the stock market, SAMA responded by smoothing the interest rate renormalization process to prevent a further decline in confidence.

There has been a noticeable increase in the number of Islamic financing transactions. To date these have mostly been in Dollars. They provide considerably cheaper financing terms than conventional equivalents because they attract an additional class of investors. However, to the extent that they are priced against conventional loans, they are affected by the interest rate environment, and so far they have not provided any policy challenge.

In a fixed rate exchange system with almost perfect asset substitutability, monetary policy cannot be autonomous, and in the case of Saudi Arabia, oil revenues and their impact on fiscal policy play a predominant role in setting the monetary scene. SAMA's policy has continued to be one of generally passive accommodation of system liquidity, and non-interference with the free workings of the market. During the past decade, when the ratio of Government debt to GDP first rose and then fell sharply, SAMA's role as a central bank and debt manager has been critical, emphasizing the dictum that monetary policy should avoid being seen as subsidizing deficit financing.

5. Summary conclusion

SAMA's monetary policy framework is firmly wedded to its fixed exchange rate policy. Given the predominance of the US Dollar in Saudi Arabia's Fx receipts and payments, the stability of the Riyal against the Dollar is relevant in the context of overall economic policy. While SAMA retains reserve requirements as a policy instrument, it uses the repo and reverse repo rates for conducting monetary policy. Short-term interest rates react to the signals sent by SAMA through the repo rate. The interest rate channel is at times augmented by administrative measures, such as setting prudential guidelines for bank credit. Fx intervention is a discretionary policy under extreme market conditions for mitigating excessive volatility in Fx swap rates. SAMA seeks to ensure that monetary and exchange rate policies are mutually consistent.

As for asset price inflation, SAMA's policy is to remain extremely cautious on targeting asset prices. This is because assessing asset price valuations is a very challenging exercise. In the aftermath of a precipitous decline in the stock market, SAMA responded by smoothing the interest rate renormalization process to prevent a further decline in confidence.

SAMA's monetary policy remains independent of its role as a debt manager for the government. Monetary conditions are set in response to overall macroeconomic considerations.

Spread between 3 month SAR and USD interbank rates