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The Saudi Arabian Economy

Policies, Achievements and Challenges

Second Edition



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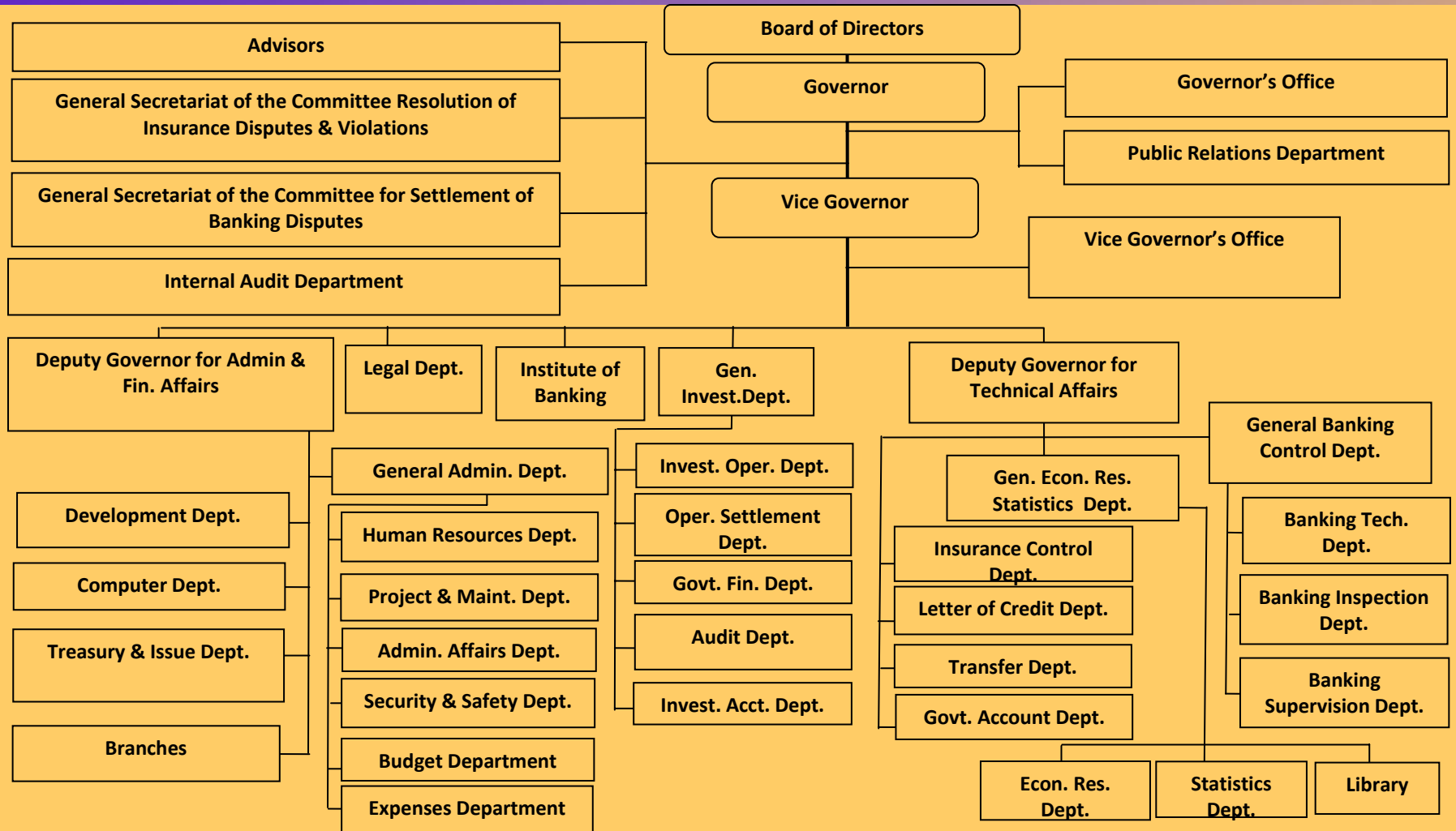
CHAPTER 4

SAUDI ARABIAN MONETARY AGENCY (SAMA) AND MONETARY POLICY

SAMA – a relatively young Central Bank but has evolved quickly to acquire powerful regulatory oversight and controls

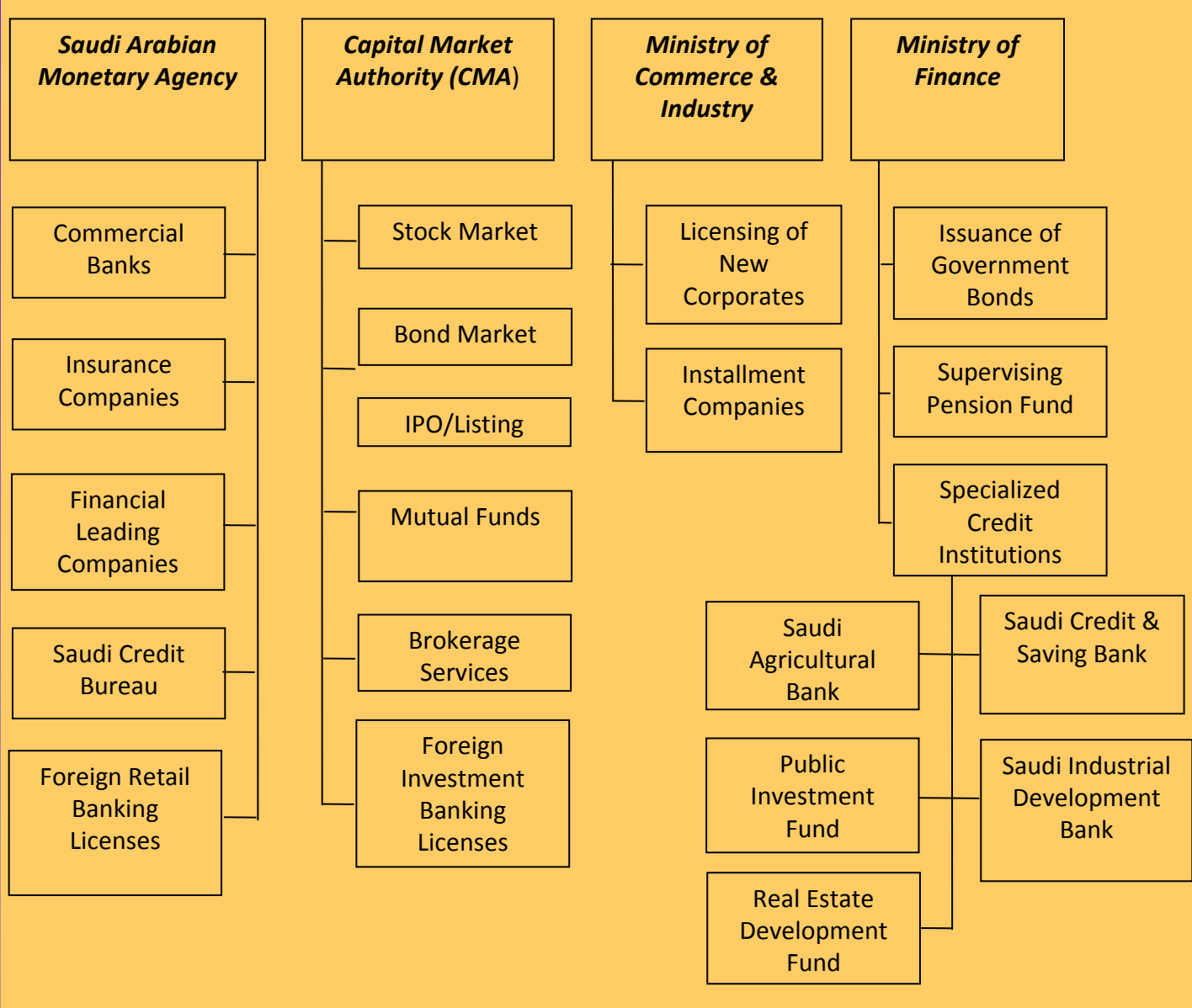
- **Established 1952. Key functions include:**
 - Issuing of national currency
 - Acting as banker to government
 - Supervising Saudi commercial banks
 - Advising government on national debt
 - Managing Kingdom's national reserves
 - Conducting monetary policy for promoting price and exchange rate stability
 - Promoting economic growth and soundness of Saudi financial system.
 - Supervision of insurance sector

Figure 4.1 SAMA's Organizational Chart



Source: SAMA

Figure 4.2. Saudi Arabia financial and economic regulatory responsibilities



Source: SAMA, 2010

Central bank monetary policy: key objectives of SAMA

- Factors that **influence** this policy are:
 - 1) Saudi Arabia's **open** economic system with no restrictions on capital flows.
 - 2) Bulk of economic activity is **oil driven** and SAMA has little control over government revenue flows.
 - 3) Vulnerability to **external** shocks.
 - 4) **Fixed exchange rate regime** against U.S. dollar which hampers SAMA independence to set interest rates.
 - 5) **Passive player** in terms of government's macro-economic objectives of minimizing impact of oil revenue swings.

Figure 4.3 Saudi economic and monetary policy responsibility

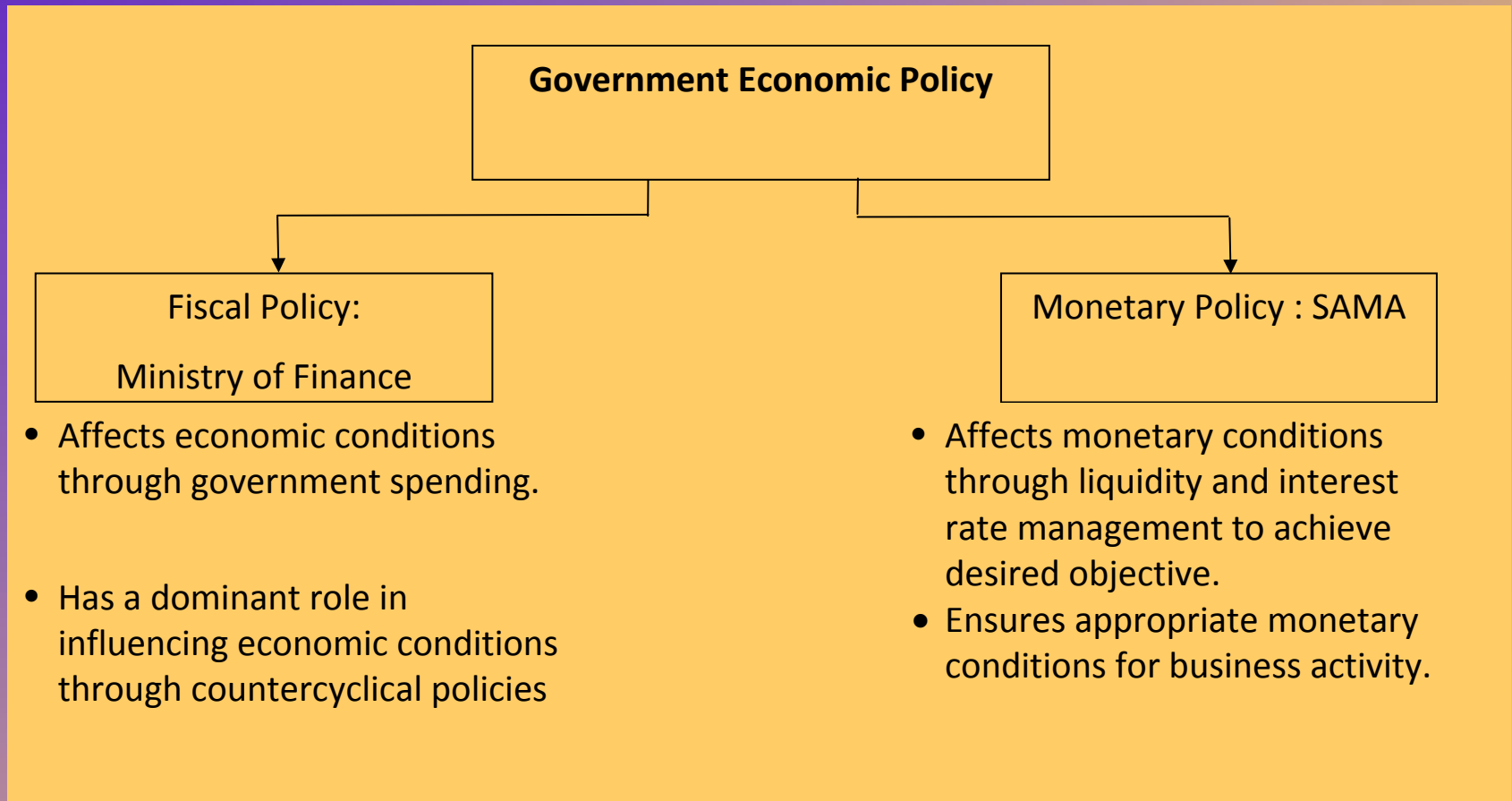


Figure 4.4 SAMA's monetary policy framework

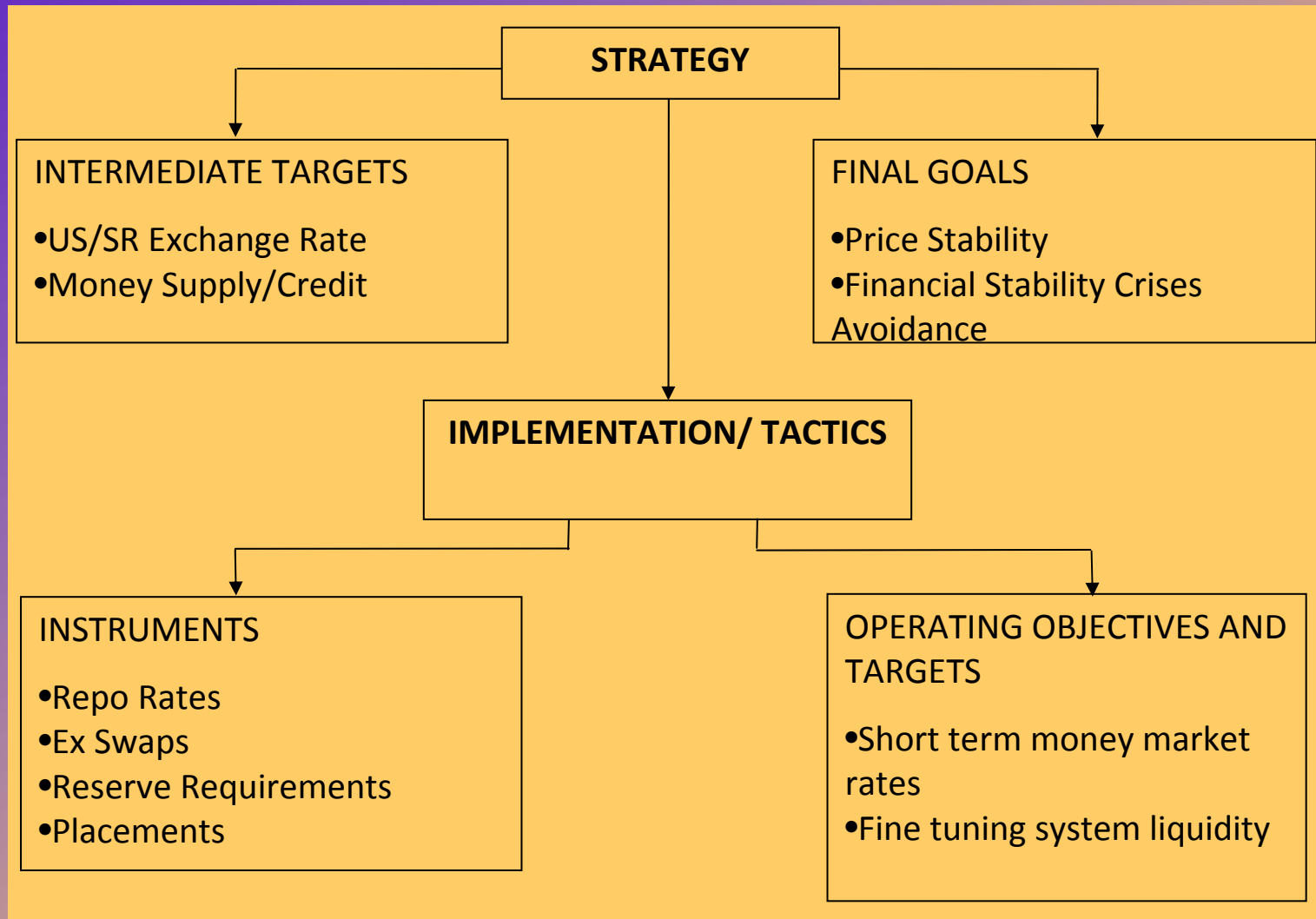


Table 4.1 SAMA's monetary policy instruments: comparative analysis

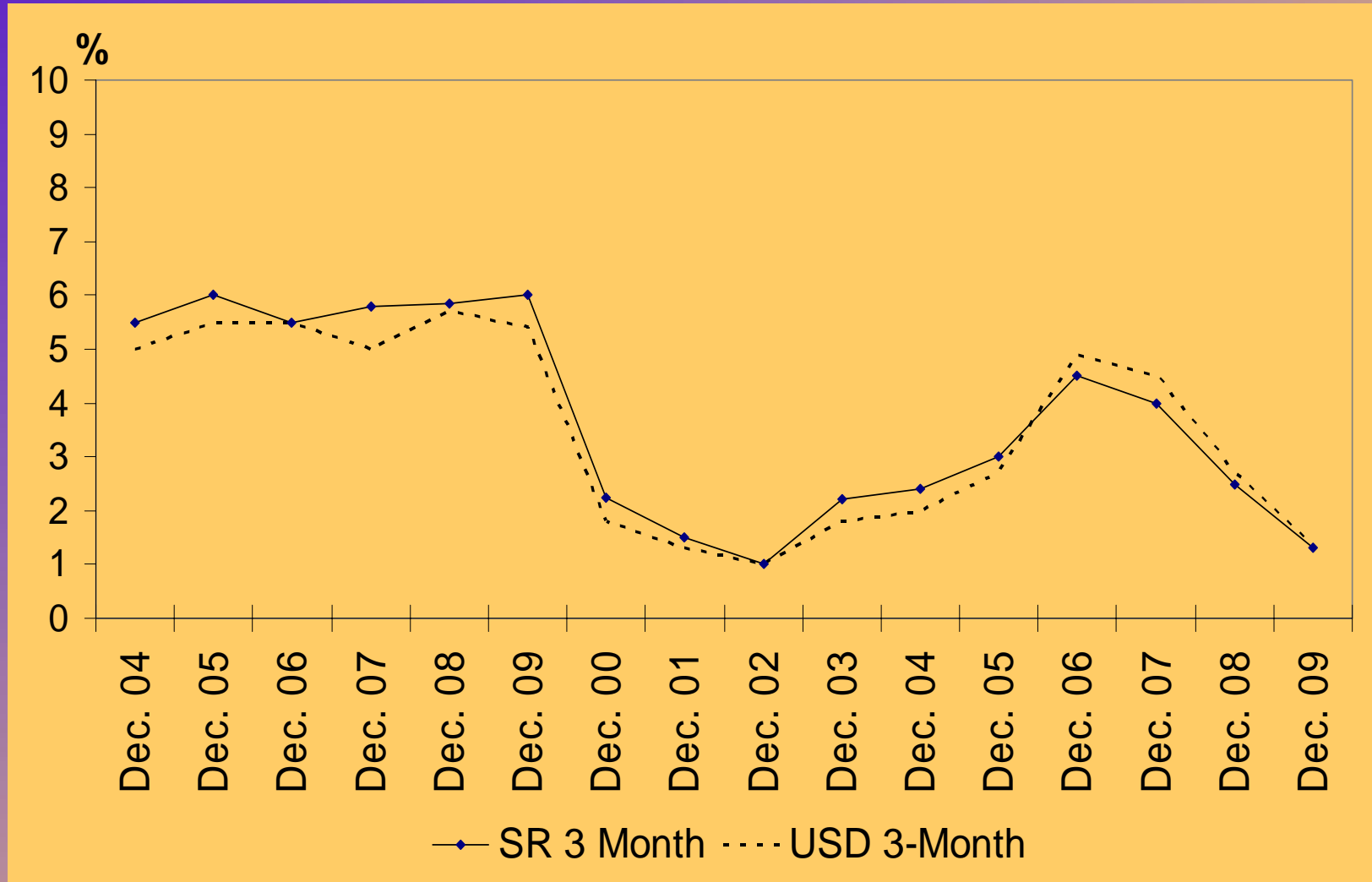
Policy Instrument Tool	Rationale, and Operational Usage	Effectiveness
Cash Reserve Ratio (CRR)	<ul style="list-style-type: none"> • To ensure banks have adequate liquidity to cover customer deposits • Raised twice in April and May 2008 from 7% to 9% and then 13% for first time since 1980, on current account and from 2% to 4% on savings account. • Reduced to 7% on current account in November 2008. 	<ul style="list-style-type: none"> • Used for implementing structural changes in bank liquidity (credit creation control) and for fine-tuning short-term liquidity • Produces strong signal effects but infrequently used • Not imposed on inter-bank transactions
Statutory Liquidity Ratio (SLR)	<ul style="list-style-type: none"> • Banks required to maintain minimum amount of specified liquid assets equal to 20% of demand and time deposits 	<ul style="list-style-type: none"> • “Free liquidity” at disposal of banks is reduced and can influence overall bank lending structure (short/long term)
Repos	<ul style="list-style-type: none"> • SAMA alters liquidity position of banks by dealing directly in the market to make temporary additions to bank reserves through short-dated repurchase agreements (overnight) 	<ul style="list-style-type: none"> • Allows for short-term injection of reserves and automatic withdrawal upon repo maturity • Efficiency depends on SAMA's holding of securities and size and depth of market
Reverse Repos	<ul style="list-style-type: none"> • Need for banks to place excess liquidity with SAMA through overnight matched sale-purchased operations 	<ul style="list-style-type: none"> • SAMA can absorb rather than provide bank reserves • A definitive purchase of financial assets reversible at short notice not affecting prices in bond market; serves to regulate the money market.
Foreign Exchange Swaps	<ul style="list-style-type: none"> • Intention to influence capital outflows, avoiding disruptions to monetary policy from foreign exchange markets • Used for liquidity management and currency speculation 	<ul style="list-style-type: none"> • More flexible than repos/ reverse repos in terms of their maturity and volume per deal • Affect liquidity but do not generally exercise influence on foreign exchange rate
Placement of Public Funds	<ul style="list-style-type: none"> • At SAMA's discretion to place governmental institutions' funds with selected banks 	<ul style="list-style-type: none"> • A “rough tuning” instrument providing banks with long-term liquidity support • Can signal crises management and problems in banks
Foreign Exchange Intervention	<ul style="list-style-type: none"> • At SAMA's discretion in times of acute speculation 	<ul style="list-style-type: none"> • Rarely used to stabilize spot and forward market.

Source: SAMA, Annual Report, 2003.

Centrality of SAMA's exchange rate policy

- ▶ In terms of economic growth theory, due to a lack of monetary interest rate independence policy, Saudi **fiscal**, not monetary policy, is central to economic growth stimulus.
- ▶ Saudi Riyal pegged to dollar at 1 \$ = SR 3.75 since 1981.
- ▶ Saudi Riyal interest rates **effectively tracks U.S. dollar** interest rates, with small premiums during periods of reduced oil prices, cuts in Saudi government expenditures or regional tensions.

Figure 4.5 U.S. and Saudi interest rates 1994-2009



Source: SAMA

Table 4.2 Advantages and disadvantages of fixed and floating exchange-rate regimes

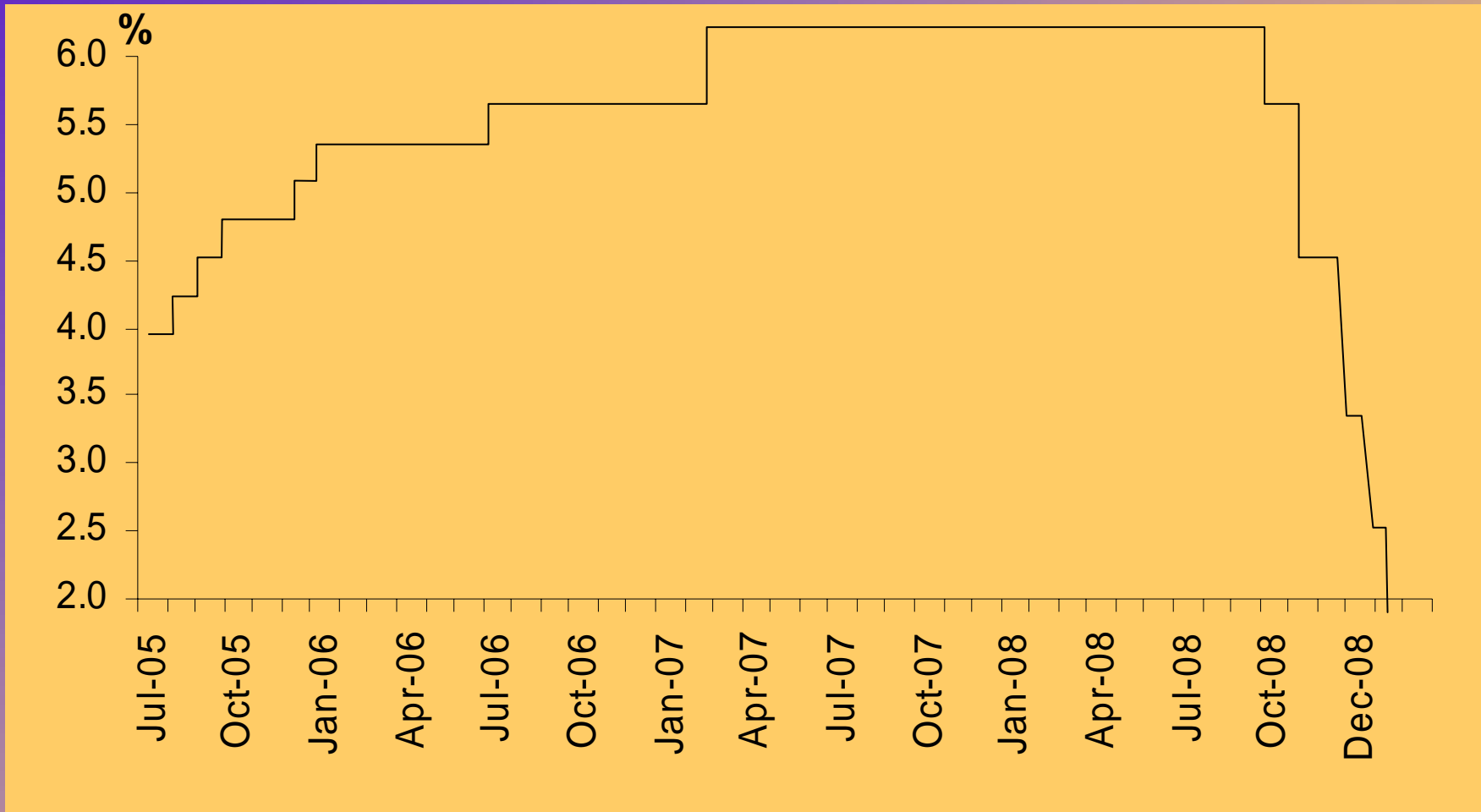
<i>Advantages</i>	<i>Disadvantages</i>
Fixed exchange-rate regimes	
<ul style="list-style-type: none"> • Maintains investors' confidence in the currency, thus encouraging domestic savings and investment and discouraging capital outflows • Reduces inflationary pressures associated with devaluation 	<ul style="list-style-type: none"> • Does not allow the implementation of independent monetary policy • Exchange rates cannot be used to adjust for external shocks or imbalances • A fixed peg is also a fixed target for speculators
Floating exchange-rate regimes	
<ul style="list-style-type: none"> • Allows pursuit of an independent monetary policy; when an economy suffers a downturn, monetary expansion can soften the impact • Allows a country to adjust to external shocks through exchange rates; that is, lower export prices and higher import prices would help the country regain external equilibrium 	<ul style="list-style-type: none"> • Reduces investors' faith in the currency, thus discouraging capital inflows to avoid exchange risk • Floating rates can overshoot and become highly unstable, leading to speculation

Source: *Adapted from Azzam, 2002, p. 98.*

Loss of independent Saudi interest rate policy

- Tracking U.S. dollar interest rates can sometimes be **counterproductive** for the Kingdom, especially during **high inflation** periods such as 2007-2008, when Saudi interest rates should have been **raised**, to dampen domestic demand , **not** reduced to track U.S. interest rate cuts .
- U.S. interest rate cuts were deemed necessary to **stimulate** the U.S. economy.

Figure 4.6. Saudi Arabia: interest rate developments (Repo Rate)

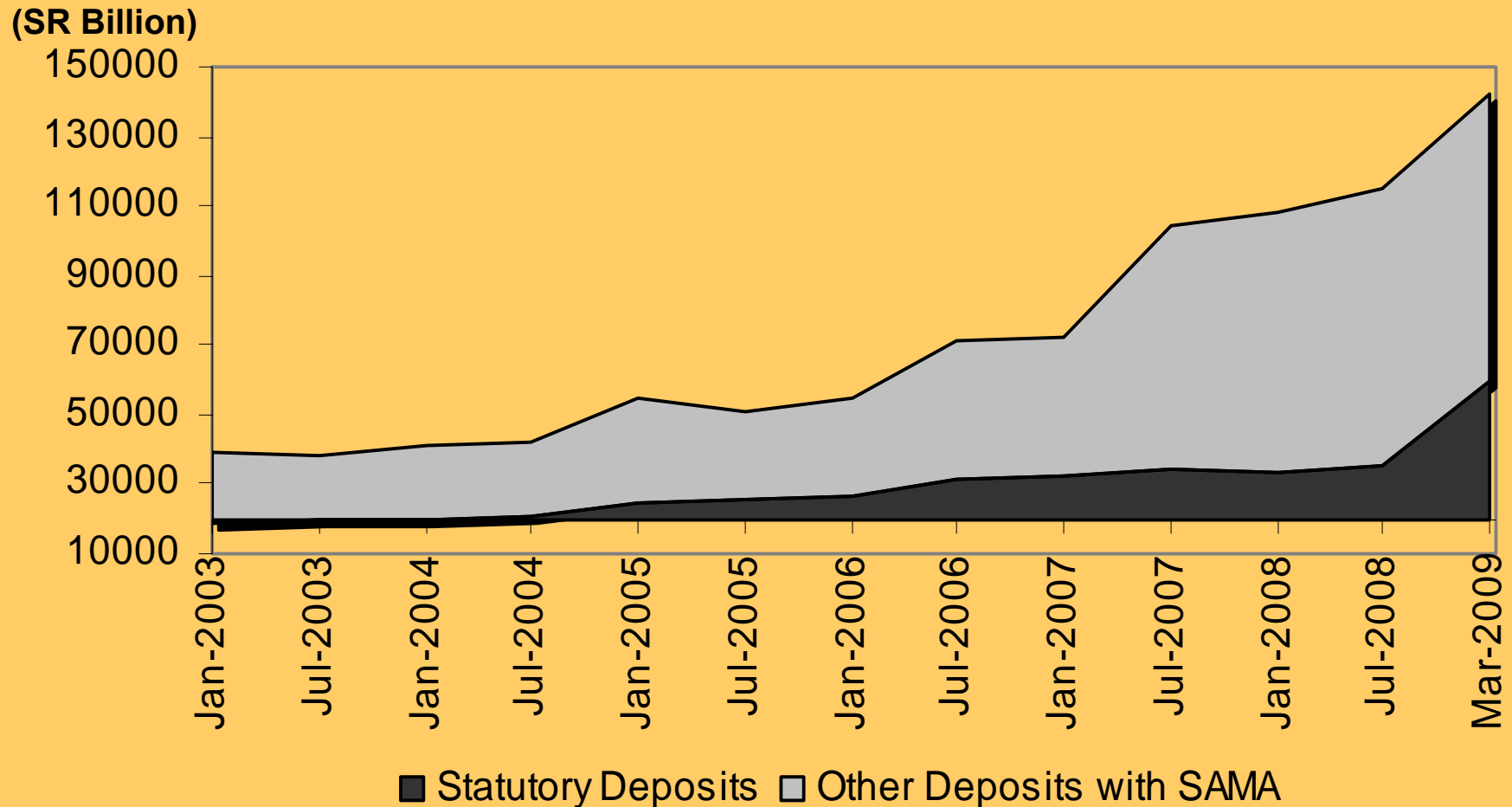


Source: SAMA

Saudi banks are well capitalized.

- ▶ Saudi bank **statutory reserves** held with SAMA are well above the international minimum Basel 8% capital requirement.
- ▶ Bears the influence of SAMA's conservative regulatory control to avoid sudden liquidity pressures due to local or regional uncertainties.
- ▶ SAMA imposes a high **Statutory Liquidity Ratio** (SLR) in comparison with banks in developed economies, making Saudi banks liquid, but in effect imposing a “**withholding tax**” on lost potential earnings on Saudi banks.

Figure 4.7 Banks reserves well above requirement



Source: SAMA

Table 4.3 Reserve position of Saudi banks (end of years)

	<i>SR Million</i>						
	<i>1999</i>	<i>2001</i>	<i>2002</i>	<i>2005</i>	<i>2007</i>	<i>2008</i>	<i>2009(Q1)</i>
A) Deposits with SAMA							
Cash in vault	5,468	3,453	4,892	7,201	10,019	4,007	10,627
Current deposits	572	197	1,750	2,238	3,143	751	1,259
Statutory deposits	10,504	12,599	14,270	21,039	36,142	44,297	46,414
Other deposits	1	2,874	7,732	2,167	59,310	41,116	79,542
Bank reserves	16,545	19,122	28,643	32,646	108,614	97,171	137,842
B) Ratios (%) to bank deposits							
Cash in vault	2.2	1.2	1.5	1.5	1.4	1.3	1.3
Current deposits							
with SAMA	0.2	0.1	0.5	0.5	0.4	0.1	0.1
Statutory deposits							
with SAMA	4.3	4.5	4.3	4.3	3.0	5.2	5.3
Other deposits with							
SAMA	--	1	2.4	0.4	8.3	4.9	9.0
Bank reserves (%)	6.7	6.8	8.7	6.7	15.1	11.5	15.6
Source: SAMA.							

SAMA relies on “open market” operations instruments to control money supply

- **Open market operations are the buying and selling of government securities to banks to affect their **liquidity** position.**
- **Since first introduced in 1986, the range of government bonds and maturities has expanded rapidly to meet the short and long term investment profile needs of Saudi banks.**

Table 4.4 SAMA: current securities offerings

<i>Security Issue</i>	<i>Currency Denomination</i>	<i>Tenor</i>	<i>Pricing</i>	<i>Offering</i>	<i>Observation</i>
<i>Treasury Bills (T-Bills)</i>	SR	1, 4, 13, 26 and 52 weeks	Saudi riyal Interbank BID rate	Weekly basis	Replaced the 180 days Bankers Special Deposit Accounts
<i>Floating Rate Notes (FRNs)</i>	SR	5 and 7 year maturities	Saudi Interbank Offer Rate (SIBOR) Plus Margin	Monthly basis	Introduced in 1996 to provide rate risk hedging
<i>Government Development Bonds (GDBs)</i>	SR	2, 3, 5, 7 and 10 year maturities	Priced to reflect relative value in alternative investments (U.S. Bonds) plus 25 - 75 basis points premium	Quarterly basis	Issued on a fortnightly basis until 1996

Source: SAMA Annual Reports.

Saudi money supply creation and monetary policy in an oil based economy

- ▶ Domestic money creation process is very much tied to the Kingdom's **ability to generate foreign currency revenues** from oil sales.
- ▶ The foreign exchange payments are **converted** to Saudi Riyal payments when drawn down by Saudi Ministries for budgetary purposes.
- ▶ **Leakages** occur when foreigners or Saudis convert Saudi Riyals to dollars and the Saudi money supply is then reduced.
- ▶ M3 money supply is affected by such net private sector balance of payment outflows.

Figure 4.8 Saudi Arabia: domestic money creation process

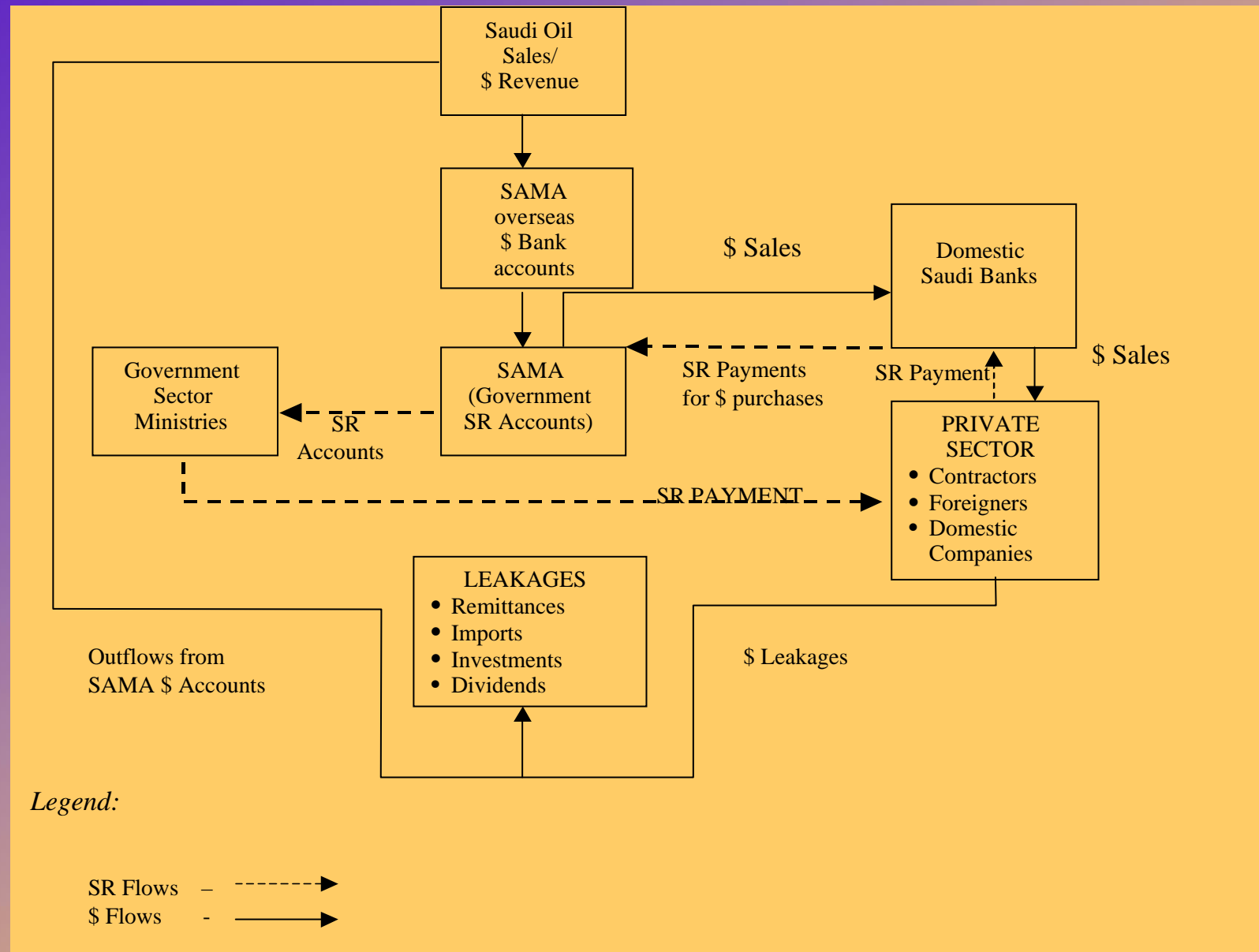


Table 4.5 Factors affecting changes in Saudi M3 (selected years)
SR billion

	1986	1989	1997	2002	2007	2008	2009 Q1
Net domestic flows through government spending ¹	71.7	69.1	145.3	154.2	461.2	339.7	101.2
Commercial banks claims on the private sector	1.2	2.8	10.1	18.8	101.9	156.7	101.2
Net private sector balance of payments	-85.7	-96.0	-121.9	-161.0	-216.1	-344.0	-130.2
Net other items ²	23.3	25.9	-24.2	37.1	-220.3	-7.7	61.1
Change in M3	10.5	1.8	9.3	49.1	129.2	139.4	131.6
Annual growth rate of M3 (%)	7.0	1.0	5.2	15.2	19.6	17.6	15.5

Note: ¹ Including net loans disbursed by government-sponsored credit institutions

² Includes payments for goods and services as well as capital outflow

Source: SAMA.

The composition of the Saudi money supply has been changing over time.

- There has been a trend since 1972 that evidences the following:
 - A gradual **rise** in time/interest bearing deposits, with M1 falling to around 48% of total money supply from 74% levels in 1972.
 - The level of **currency** held by the public has fallen to around 9% levels by 2009 ,compared with 44% levels in 1972, as people became more accustomed to dealing with banks.
- This has led to “**financial deepening**” of the Saudi financial system, with a higher level of monetization to GDP and mobilization of long term assets to GDP.

Table 4.6 Saudi Arabia monetary ratios (%)

<i>End of Year</i>	<i>Currency/M3</i>	<i>M1/M3</i>	<i>M2/M3</i>
1972	44.4	73.3	88.8
1982	25.5	64.1	86.2
1997	16.8	51.9	80.3
1998	16.0	49.7	79.3
1999	18.3	52.0	80.4
2000	16.2	52.6	81.5
2001	14.9	54.3	82.1
2002	13.7	53.2	81.6
2003	14.2	54.4	81.8
2004	12.1	54.4	82.2
2005	12.1	51.2	81.3
2006	10.5	47.3	81.6
2007	9.3	48.6	84.4
2008	8.9	45.8	85.4
2009(1Q)	8.6	47.6	84.5

Source: SAMA

Table 4.7 Financial deepening in Saudi Arabia (%) 1971 – 2008

<i>Year</i>	<i>K</i>	<i>Z</i>	<i>KK</i>
1971	62.9	13.8	11.3
1973	52.4	13.6	11.7
1979	41.6	21.9	20.2
1986	44.3	39.0	16.1
1990	43.7	36.1	26.1
1997	32.4	35.3	22.8
2000	30.9	36.2	23.4
2001	27.3	38.8	25.6
2002	26.2	39.9	26.9
2003	25.4	42.4	28.2
2004	22.16	56.4	29.2
2005	22.67	53.2	37.1
2006	22.17	68.5	39.7
2007	18.82	82.0	47.2
2008	19.51	93.4	50.1

Legend: K- Currency Ratio (cc/M1)

Z - Monetization Ratio (M2/GDP)

KK - Mobilizing longterm assets (M1/GDP)

Source:SAMA

Saudi inflation control has become an important policy issue

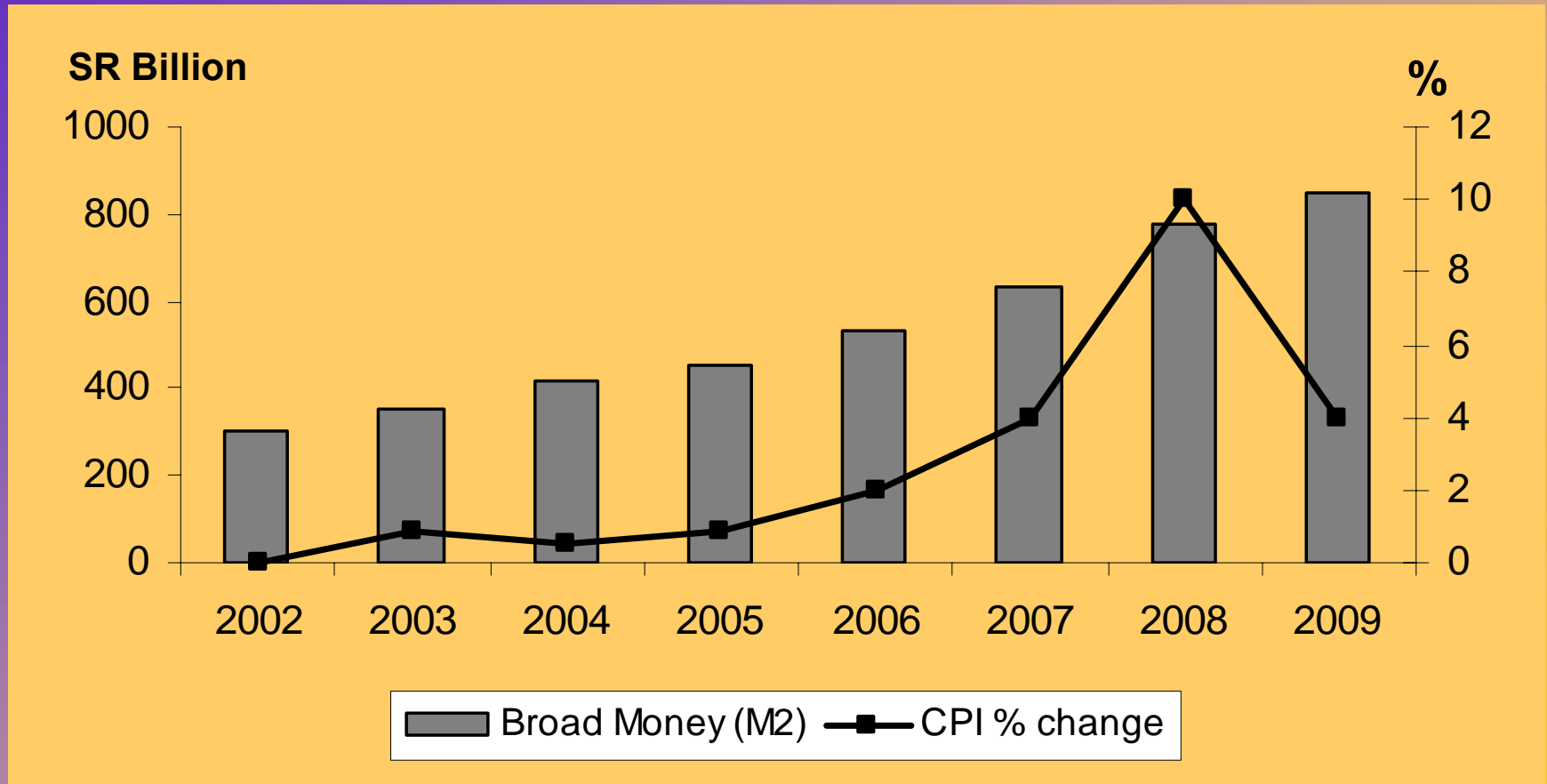
- According to SAMA, monetary policy continues to be geared to the objective of **maintaining domestic price and exchange rate stability**.
- **Inflation** reached 30% peaks in the early 1970's boom era ,before subsiding, but rose again to under 10% levels in 2007/2008.
- Increased government expenditure, rise in money supply plus external trade factors (decline in dollar value, commodity price rises and domestic supply shortages) were also contributing factors.
- The income velocity of money was **not** a primary factor in the most recent rise in Saudi inflation.

Table 4.8 Annual growth rates of selected indicators, including inflation (2005-2008)

	2005	2006	2007	2008
Non-oil GDP deflator (1999 = 109)	4.1	3.7	1.6	2.4
Cost of living index (1999 = 108)	0.7	2.2	4.1	9.9
Non-oil GDP (at constant prices)	5.2	5.1	4.7	4.3
Government Expenditures	21.5	13.5	18.5	11.5
Money Supply (M3)	11.6	19.3	19.6	17.6

Source: SAMA.

Figure 4.9 Saudi Arabia money supply growth M2 and CPI % change



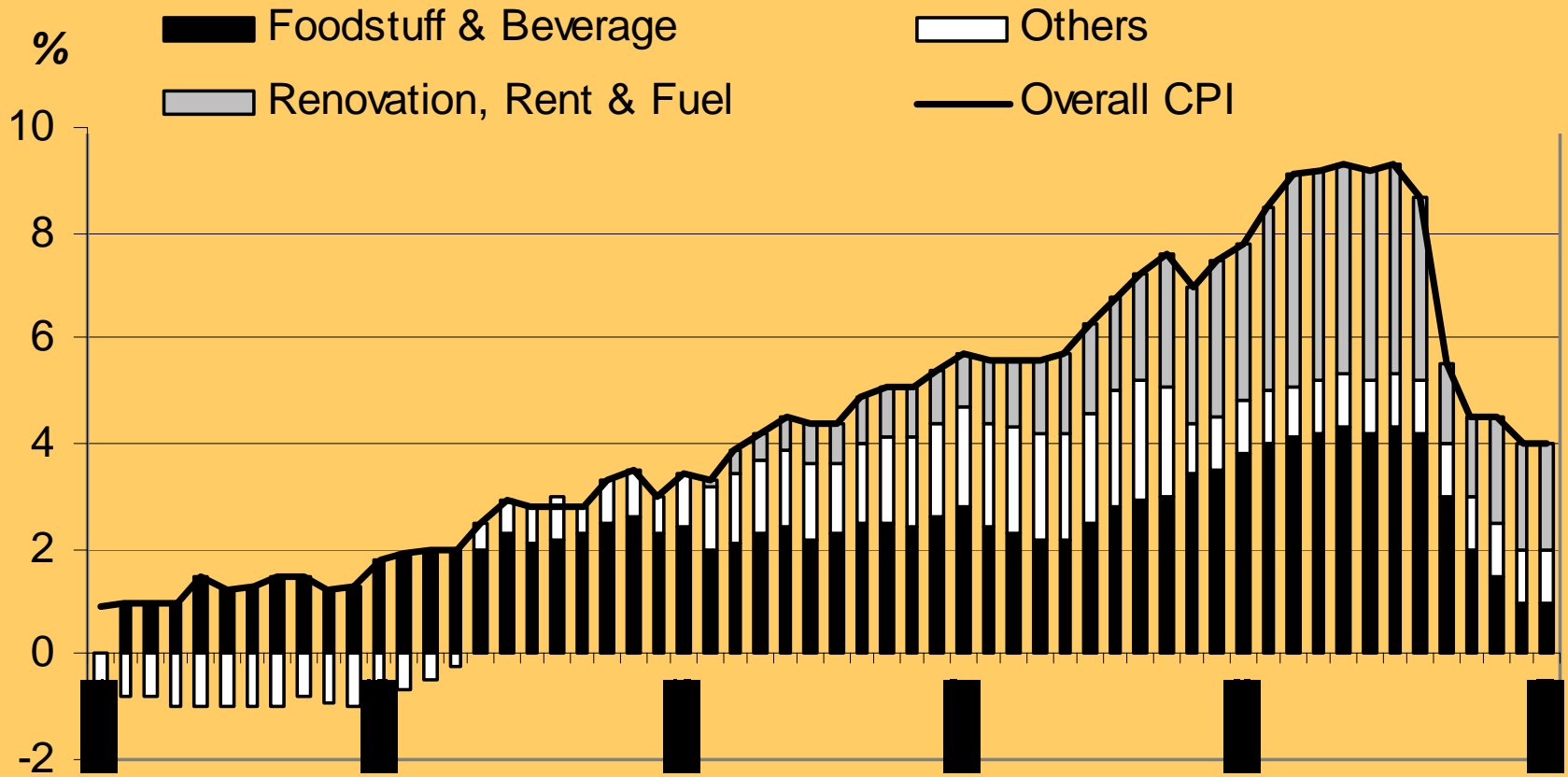
Source: SAMA

Table 4.9. Income velocity of money (non-oil sector) 1998-2008

<i>Years</i>	M^1	M^2	M^3
1998	3.82	2.46	1.98
1999	4.12	2.64	2.11
2000	4.42	2.86	2.32
2001	3.94	2.60	2.13
2002	3.66	2.46	2.01
2004	2.11	1.14	1.14
2005	2.04	1.32	1.07
2006	2.09	1.25	1.02
2007	1.92	1.10	0.91
2008	1.67	0.96	0.80

Source: SAMA.

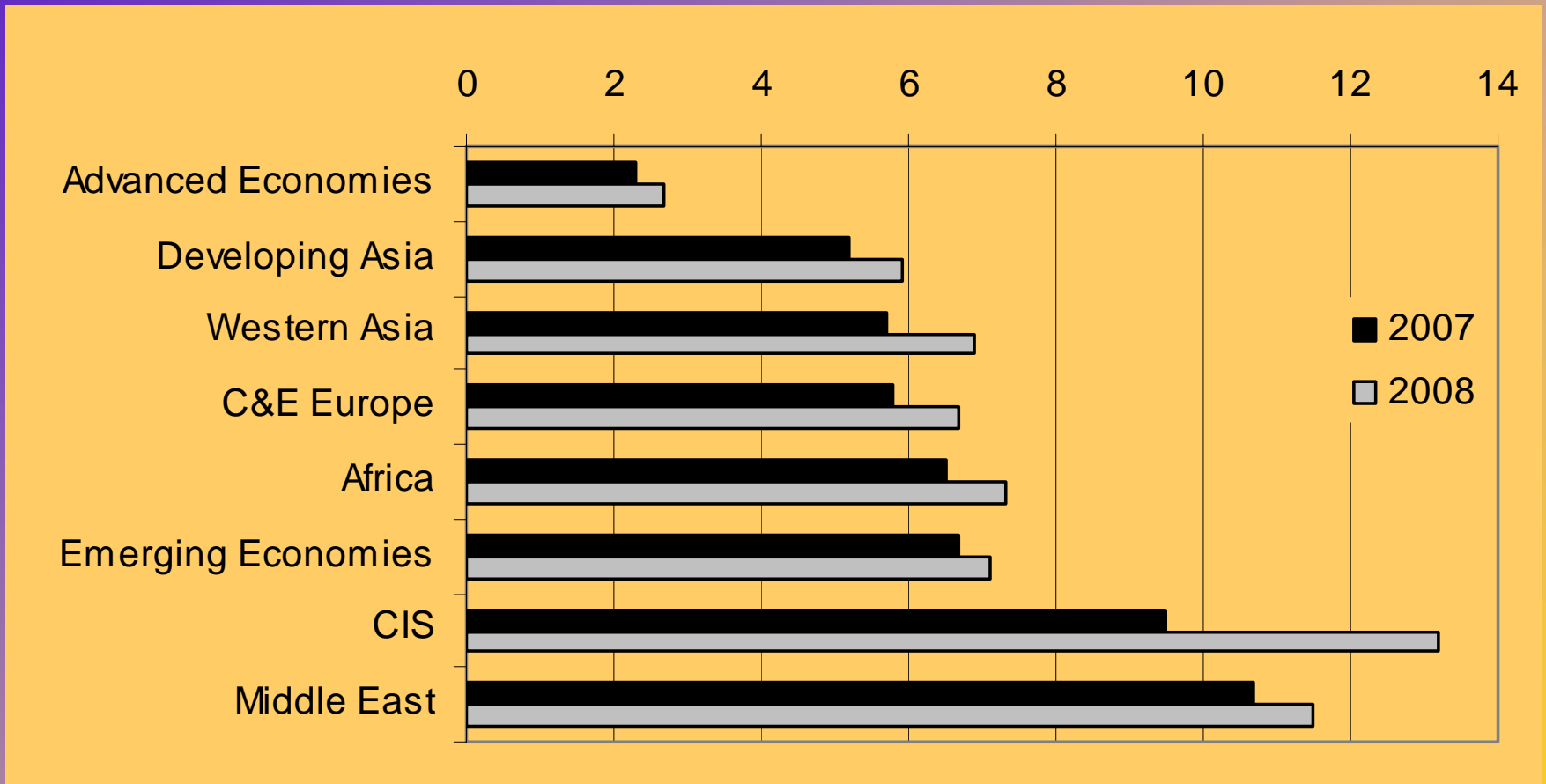
Figure 4.10 Drivers of inflation



Source: SAMA

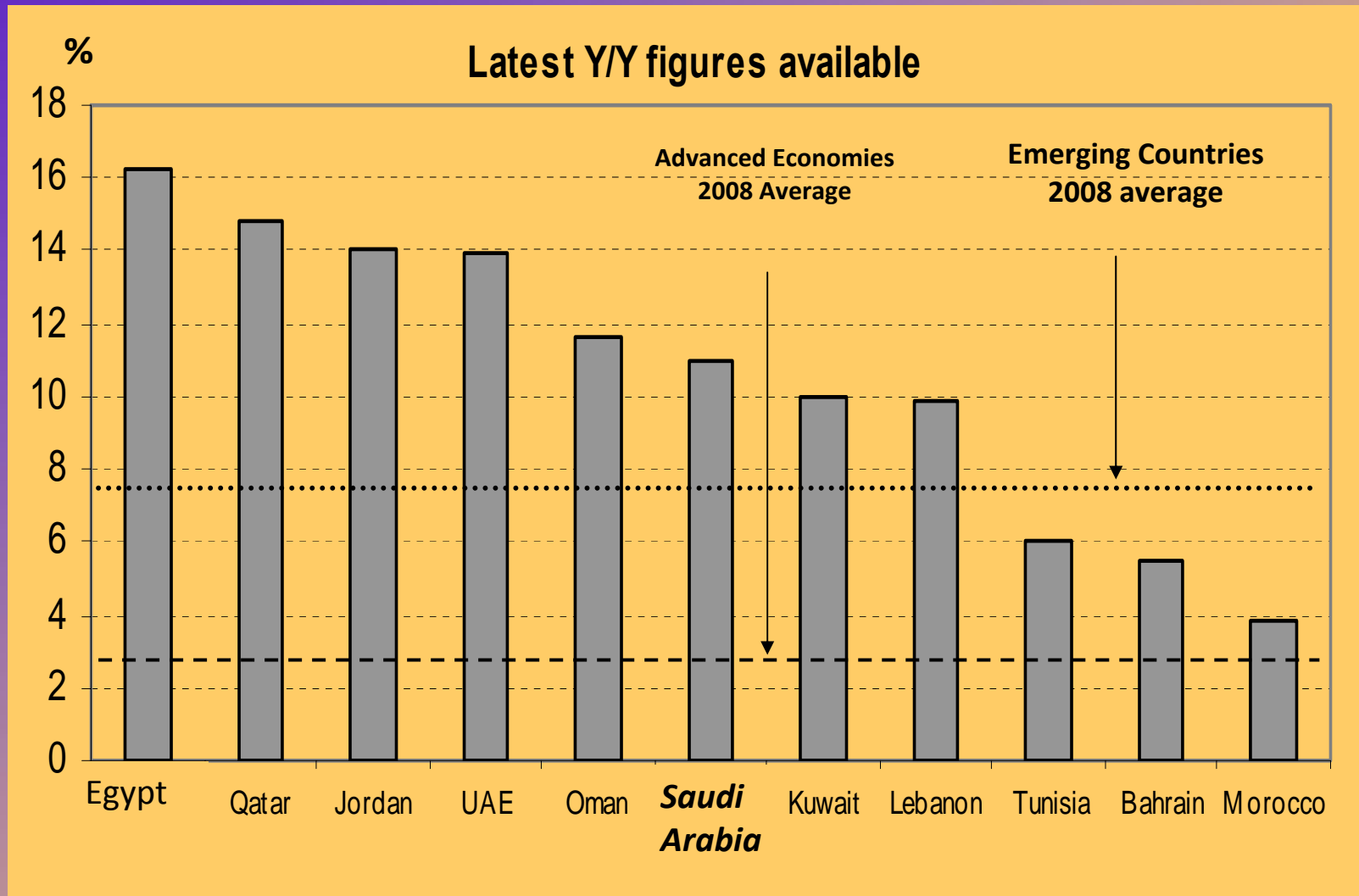
- **Middle East inflation levels** are the second highest after the Commonwealth of Independent States (CIS) and other emerging economies.
- In the GCC region, Bahrain has the lowest inflation levels ,while Qatar and the UAE have the highest levels of inflation.

Figure 4.11. Regional inflation rates (%).



Source: *IMF*

Figure 4.12. Monthly inflation rates Middle East countries

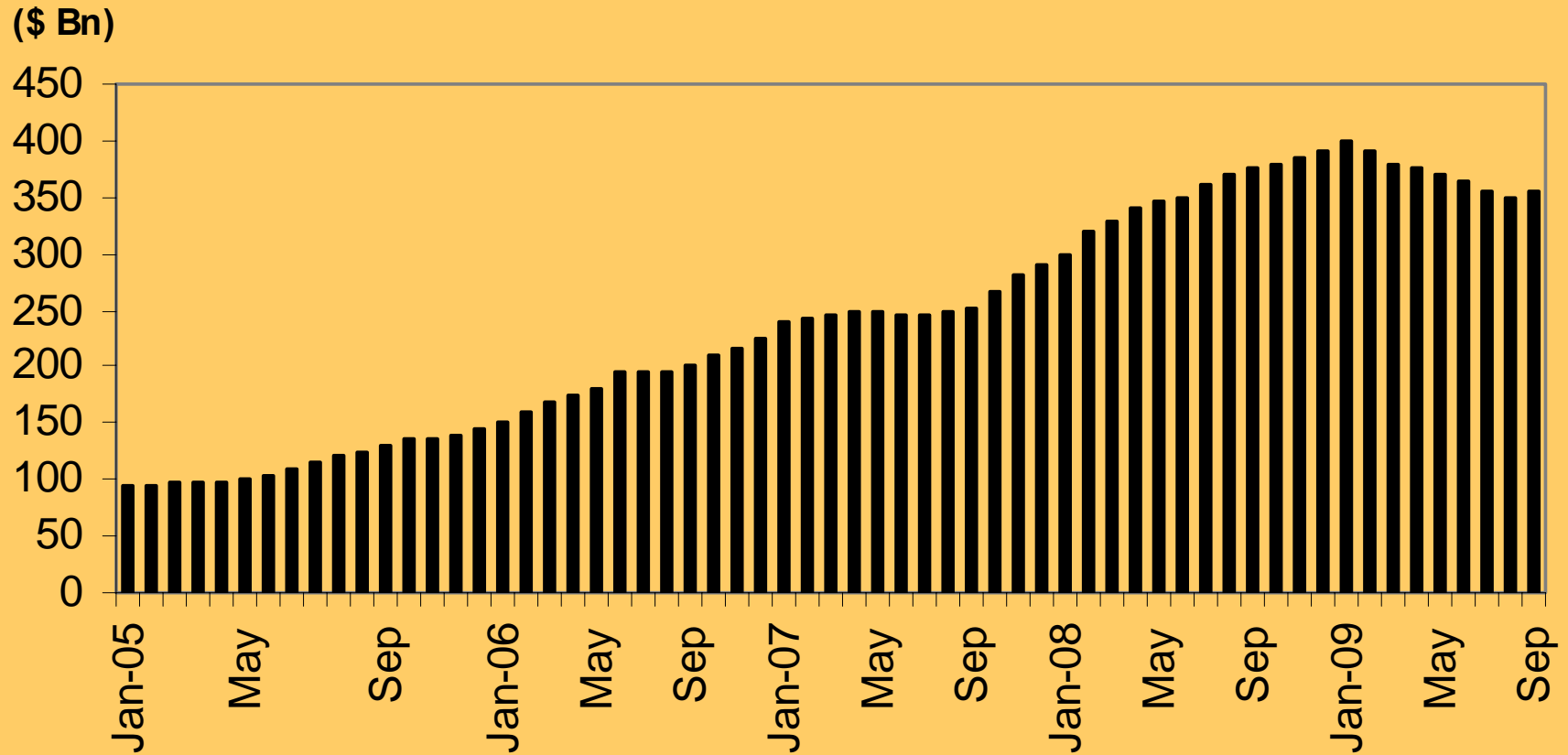


Source: *IMF*

Managing the Kingdom's foreign reserves: a key SAMA objective

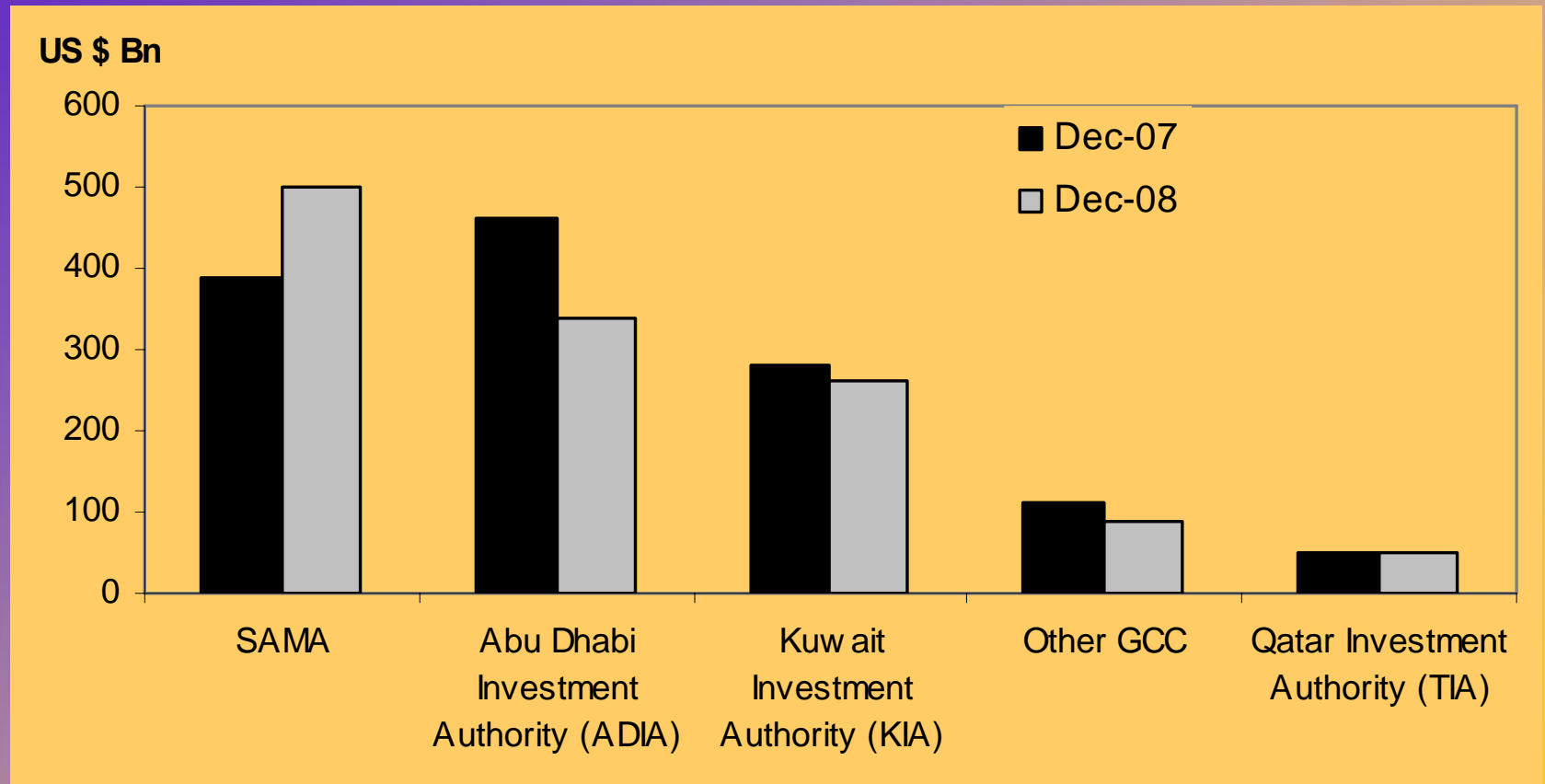
- SAMA's foreign reserves **management policy** aims to achieve the following **objectives**:
 - Principal value preservation. U.S. dollar is used as base currency.
 - Maximizing liquidity and returns
 - Achieve risk adjusted returns
 - Diversify assets amongst major international banks based on their credit rating, minimum of “C” rating.
 - Portfolio benchmarking and performance measurement such as JP Morgan Global Bond Index
- Global financial crisis of 2008/2009 did not affect SAMA as much as other Sovereign Wealth Funds of the Gulf who invested in equities.

Figure 4.13. SAMA net foreign assets



Source: SAMA

Figure 4.14. Assets under management by SAMA and Regional SWF



Source: SAMA, IMF

Future developments and challenges for SAMA

- SAMA is faced by several **domestic and international challenges**. These include:
 - **Legislating** for control of expansion of range of financial services in conformity with global liberalization of financial services especially in the insurance sector.
 - **Overseeing** the introduction of the Saudi Commercial Mortgage Law.
 - The increasing importance and popularity of **Islamic financing**.
 - Overseeing the new wave of **foreign bank licenses** in Saudi Arabia since the era of “**Saudization**” of foreign bank branches in the early 1980’s.
 - Effective participation in the proposed unified **GCC Monetary Union**.

Table 4.10 Challenges faced by SAMA

<i>Short-term</i>	<i>Medium-term</i>	<i>Long-term</i>
<ul style="list-style-type: none"> • Control of money laundering and terrorism funding 	<ul style="list-style-type: none"> • Establishing guidelines for Islamic banking supervision and regulation 	<ul style="list-style-type: none"> • Effective participation through Islamic Banking Financial Services Board
<ul style="list-style-type: none"> • E-commerce application and internet banking 	<ul style="list-style-type: none"> • Ensuring Saudi banks comply with new BIS capital adequacy ratios 	<ul style="list-style-type: none"> • Effective participation in Gulf Cooperation Council Monetary Union and proposed single currency for GCC
<ul style="list-style-type: none"> • Ensure Saudi banks are adequately prepared following WTO accession 	<ul style="list-style-type: none"> • Supervision and integration of newly licensed foreign banks into Saudi banking system 	<ul style="list-style-type: none"> • Implement fine tuning instruments for inflation targeting
<ul style="list-style-type: none"> • Overseeing effective Saudization of bank personnel 	<ul style="list-style-type: none"> • Effective participation in international financial supervisory standards 	<ul style="list-style-type: none"> • Supervision and regulation of cross-border Saudi bank mergers and acquisitions
<ul style="list-style-type: none"> • Establishment of data base and supervision of the insurance sector 	<ul style="list-style-type: none"> • Supervision and regulation of non-bank financial institutions into the markets such as mortgage lenders 	<ul style="list-style-type: none"> • Re-examine SR/U.S. dollar fixed exchange parity policy and exchange rate targeting mechanism.
<ul style="list-style-type: none"> • Completion of mergers of local money exchangers into one financial institution 	<ul style="list-style-type: none"> • Develop secondary market instruments for capital market 	<ul style="list-style-type: none"> • Apply lessons from 2008/2009 financial crisis in terms of vigilance on capital requirements and liquidity cushion.
<ul style="list-style-type: none"> • Overseeing partial privatization of government-held bank shares in capital market 	<ul style="list-style-type: none"> • Upgrade SAMA's Banking Training Institute to provide broader financial services expertise 	<ul style="list-style-type: none"> • Ensure better risk management processes control and corporate governance. • Initiate macro economic monetary policy forecasting models and publish minutes of policy meeting and decisions for private sector guidance.

Conclusion

- **SAMA's inflation control policies will become more important and new mechanisms will have to be adopted.**
- **Managing the branches of foreign banks operating in Saudi Arabia post 2005 WTO accession, especially to avoid any global financial contagion, will be a key challenge for SAMA.**

(Contd...)

- Supervising Saudi **cross-border branching** will also be a challenge, as more Saudi banks venture abroad.
- The issue of the unified **GCC Monetary Union** and the implication on Saudi monetary policy is also a challenge to Saudi monetary policy.
- **Islamic financing** is becoming an important segment and SAMA has indicated that it can supervise such new instruments and banking specialization.