Foreign exchange intervention in Saudi Arabia

Abdulrahman Al-Hamidy[1] and Ahmed Banafe[2]

Abstract

Saudi Arabia has a fixed exchange rate regime, with a dollar peg. The spot USD/SAR exchange rate has remained unchanged at 3.7500 since June 1986, as SAMA provides dollars to the domestic banks to meet the commercial and financial demand of the private sector. SAMA FX intervention has been discretionary and infrequent, mainly in the forward market, to stem speculative activity linked to external or domestic factors. It has not been SAMA policy to intervene for broader economic objectives, such as controlling inflation, maintaining competitiveness or regulating the amount of FX reserves, as these are amply addressed by fiscal measures rather than FX intervention in a pegged exchange rate regime, which is the economy's nominal anchor.

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[1] Vice Governor, Saudi Arabian Monetary Agency.

[2] Senior Investment Advisor, Saudi Arabian Monetary Agency.

1. Introduction

The Saudi riyal has been at a fixed rate to the US dollar since June 1986 (SAR 3.7500 per USD). Foreign exchange earnings come predominantly from oil exports, which are deposited with the Saudi Arabian Monetary Agency (SAMA). In turn, SAMA credits the government's account with the equivalent riyals. Therefore, SAMA is responsible for meeting the foreign exchange needs of the public and private sectors by selling dollars against riyals to the domestic banks.

SAMA last intervened in the foreign exchange market in 1998. This took place in the forward market, because speculation tends to be in the forward market since banks can treat it as an off-balance-sheet item. Speculation against the riyal occurred in the 1990s at times when the oil market was weak and foreign exchange reserves were falling. More recently, in 2007/08, there was an episode of speculation in favour of the riyal due to Saudi Arabia's strong balance of payments and fiscal position, a weaker dollar, and rising domestic inflation. SAMA handled this more recent episode by reiterating its long-standing position to uphold the exchange rate regime without actual intervention.

2. Macroeconomic background

Saudi Arabia is an oil-based economy and relies on oil revenue for the bulk of its budgetary spending. Oil revenue averaged 87% of total revenue during 2003–2011. The non-oil private sector represents about 49% of real GDP (or 25.5% of nominal GDP – which is because since 2003 the oil market has been strong, driving the share of nominal oil GDP noticeably). Saudi Arabia's real GDP growth has averaged 4.5%, and the domestic cost of living index rose at an annual average of 3.7% between 2003 and 2011. During this period the average budget surplus has been 12.5% of GDP. Saudi Arabia's debt/GDP ratio has fallen significantly – from the peak of 103.5% in 1999 to under 4% currently – due to cumulative budget surpluses over the recent years. BoP surplus/GDP averaged 20.6% in the 2003–2011 period.

The fixed exchange rate regime reflects the reality that adjusting the exchange rate has no effect on the competitiveness of oil exports in the global economy, which are priced in dollars. The fixed exchange rate has allowed riyal interest rates to track US dollar rates within a permissible deviation that reflects domestic market conditions. There is 100% currency backing by foreign exchange reserves, so that currency issued cannot exceed foreign exchange assets (Article 6 of Saudi Arabia's Currency Law).

Forward intervention in the foreign exchange market could be problematic if a country had high short-term foreign currency liabilities and a weak banking system. Saudi Arabia has a net creditor position externally and a strong and conservatively supervised banking system. This means that it has not been difficult to tackle the occasional speculation in the forward market either by intervention or by prudential measures. SAMA could insist on gross actual settlement of forward transactions (as opposed to net settlement), thus forcing counterparties speculating against the riyal to make payments in riyals to take delivery of their forward dollar purchases. Because SAMA has full control over the supply and availability of riyals, it can in effect prevent the development of an offshore riyal market.

3. Governance

The foreign exchange regime is selected by SAMA in consultation with the government. FX intervention is at the discretion of SAMA, acting within the confines of the exchange rate regime. Intervention is occasional and aimed at preserving exchange rate and financial stability. Intervention is not used to accumulate foreign exchange reserves or to strategically change the portfolio decisions of domestic and external operators (e.g. SAMA has not to date signalled any indication that it is considering adjusting the exchange rate regime to attract foreign capital).

4. Causes of speculation

In the two intervention episodes of the 1990s (1993 and 1998), speculation was linked to external events. SAMA follows trends in the forward foreign exchange market closely to pick up on the movement in forward prices. In 2007/08, there was speculation on a possible revaluation of the riyal, given Saudi Arabia's strong macroeconomic condition against the background of a weak dollar. Episodes are signalled by media comment and generally come from outside via a contagion effect, with the focus being primarily on the oil price and revenue outlook.

Saudi Arabia's external and domestic budgetary situation varies with developments in the global oil market. When the oil market is weak, Saudi Arabia runs external and budgetary deficits. The external deficit is met by running down foreign exchange reserves, and the budgetary deficit by issuing government bonds. When the oil market is strong, the cycle moves so that Saudi Arabia is in surplus externally and domestically. Foreign exchange reserves are replenished and the budget surplus results in a pay-down of government debt. Through these mechanisms the volatility of the resource-based economic cycle is dampened. Ultimately, the success of this approach depends on keeping enough foreign exchange reserves in hand at the bottom of the cycle.

Speculators misunderstand the use of countercyclical fiscal policy and project the current situation forward, treating the oil market as a trigger for speculation. There is a perception that devaluing the riyal would translate into higher budgetary revenue. But this is an accounting rather than a real phenomenon, as oil production is not stimulated by a change in the USD/SAR exchange rate (unlike more diversified economies, where devaluation tends to stimulate exports). Likewise, the effect on foreign exchange reserves is purely an accounting event. Since the propensity to import is relatively high, even purely domestic government spending (e.g. payrolls) results in a foreign exchange outflow.

Similarly, revaluing the riyal when oil revenues were strong would not have a marked effect on the domestic economy. While import prices might drop to some extent, this would be offset by higher imports due to the wealth effect of a revalued riyal in the hands of domestic consumers.

5. Intervention tactics and their effectiveness

In episodes of speculation against the riyal (as were seen in 1993 and 1998), SAMA's tactics were effective, and they are still available for use. In the forward market, foreign exchange swap points rise as speculators buy dollars forward against the riyal. The domestic banks, acting as market-makers, adjust their forward quotations, and aim to cover their short forward dollar positions by buying dollars from SAMA. There is a drain on system liquidity, and riyal rates tend to rise. Longer-dated forwards can be targeted specifically with the aim of destabilising the market and feeding more speculative activity.

SAMA responds both passively and actively. Passively, SAMA keeps providing spot dollars to the domestic banks to meet the commercial and financial demand of the private sector so that speculators find it difficult to distort the spot riyal rate. Actively, SAMA's policy has been to intervene on a discretionary basis in the forward market, given speculators' preference to target the forward market. SAMA's approach of gathering relevant information from the domestic banks (i.e. learning about the size of open positions, trading volumes and the origins of transactions) has proven to be helpful and successful without a need for large scale intervention. Supportive actions have included liquidity injection through deposit placements with the domestic banks, and use of foreign exchange swaps in order to achieve the maximum possible effect on lowering swap points (i.e. buying USD/SAR spot and selling forward).

When the speculation is in favour of the riyal, a wider range of tactics is available. In theory, riyal interest rates could be cut to make holding riyals less attractive and reduce the positive carry for speculators. But this would have consequences for the economy as a whole. Prudential steps have proved effective. In 2007/08, SAMA raised the minimum reserve requirements for domestic banks. This curbed excessive money supply growth, drained liquidity from the system and made it more difficult for speculators to acquire the riyals they wanted. During 2007 and 2008, the reserve requirement was raised in aggregate from 7% to 13% for demand deposits and from 2% to 4% for time and savings deposits. At the same time, the government took action to cut import tariffs and subsidise basic imported foodstuffs, thus dampening media comment that rising food prices might force a revaluation of the currency. Consumer price inflation peaked in July 2008 at 11.1%, and SAMA gradually brought the reserve requirement down by November 2008 to 7% for demand deposits, leaving it unchanged at 4% for time and savings deposits.

6. Cost of speculation, and domestic implications

Given the stability of the peg, riyal interest rates track dollar rates closely. Higher interest rates are often viewed as an important weapon in the fight against speculators, but this would have cost implications for business investment and economic growth. In the 1990s episodes, intervention was small-scale and ultimately profitable when forward contracts were liquidated.

In the 2007/08 episode, co-ordinated prudential measures were taken rather than cutting interest rates. Fiscal costs were incurred to reduce prices of basic foodstuffs. SAMA incurred no direct costs, and raising reserve requirements curbed excessive money supply growth without raising rates. In summary, prudential measures were successful.

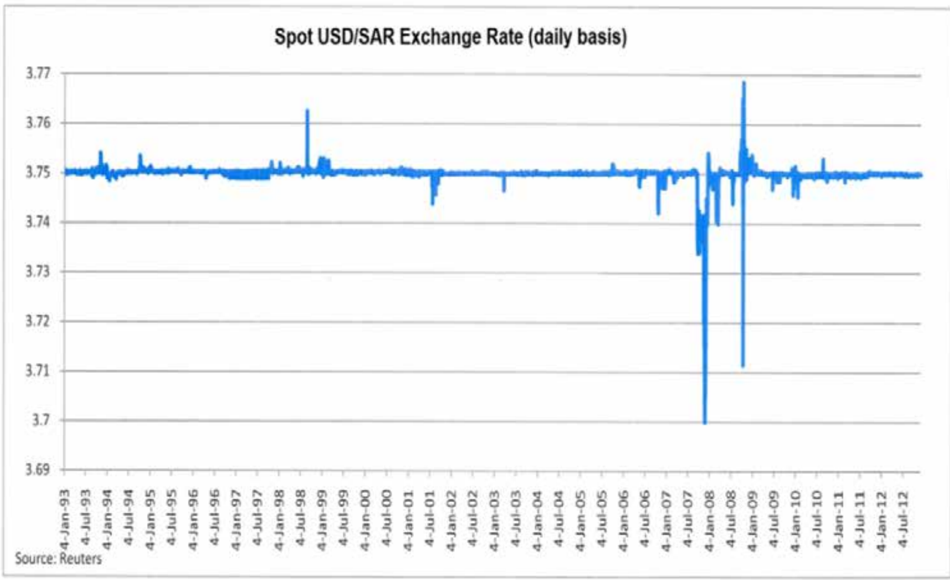
Since the government is the sole recipient of oil revenue, SAMA is the major source of dollars to the banks. Routine sales meet the financial and commercial demands. Given this steady supply, speculation against the riyal has been in the forward market. There has been no need to sterilise the small-scale interventions.

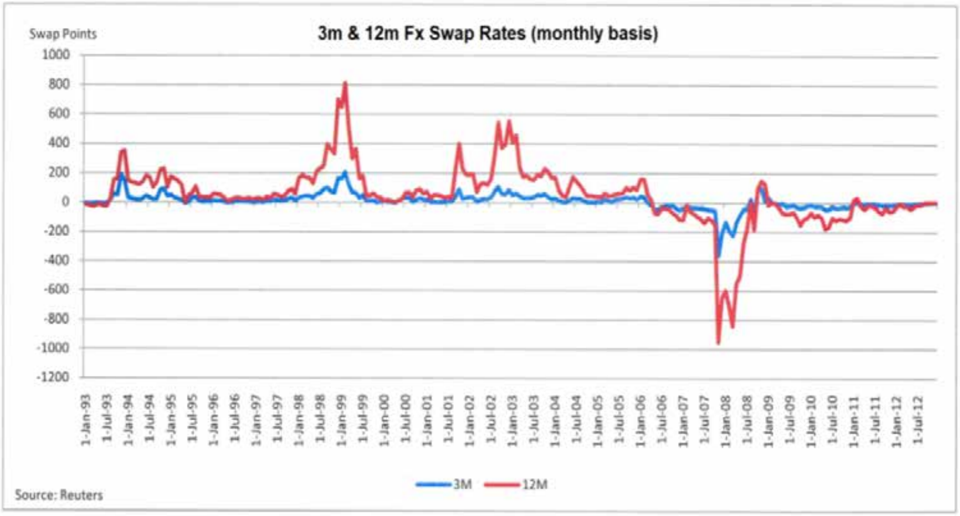
7. Conclusions

Speculation can take place for and against the riyal as speculators extrapolate the state of the oil market and underestimate authorities' resolve to defend the peg, which is the lynchpin of the strategy to reduce the volatility of economic growth. In particular:

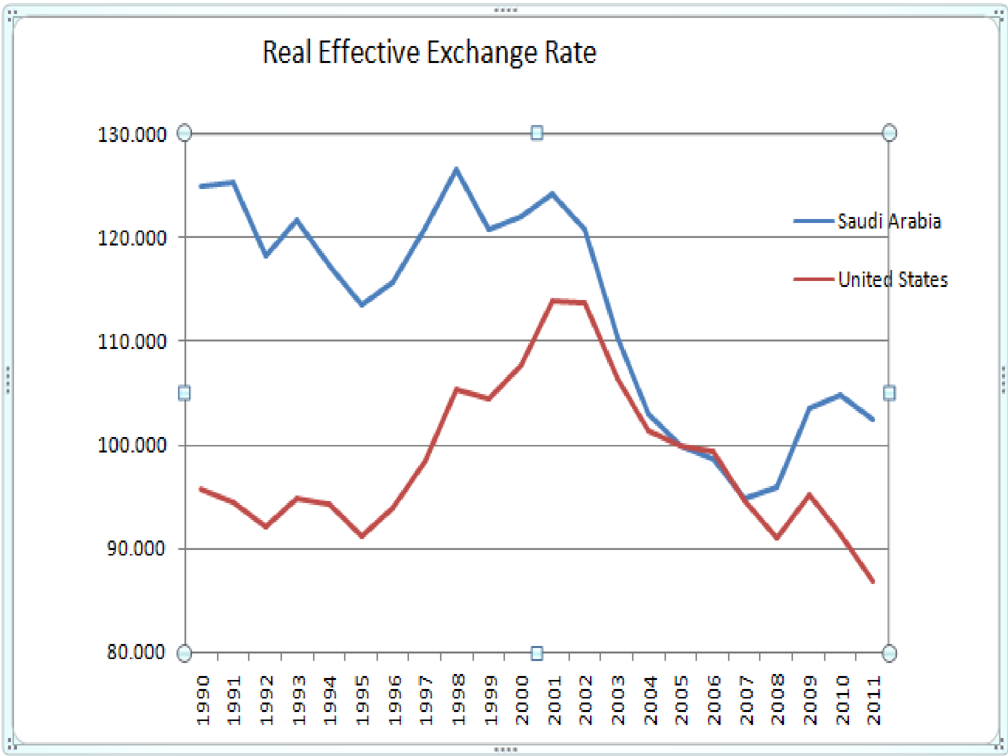
- SAMA kept itself closely informed about market developments and was able to break the 1990s speculation against the riyal through small-scale forward FX interventions. In the 2007/08 episode (i.e. speculation on the riyal), active intervention was not needed, since prudential measures to curb system liquidity were adequate. SAMA accommodated the banks by buying spot USD against SAR from the market, while at the same time tightening monetary conditions for domestic reasons by raising reserve requirements, since interest rate hikes would have exacerbated the demand for riyals.
- Given SAMA's discretion on controlling the supply and availability of riyals, gross settlement of forward transactions can be required, and this implies that even longer interventions may not lead to a noticeable drain of reserves.
- Interest rates continued to be set for domestic reasons, so that the episodes had a relatively limited effect on business investment and growth.

To date, SAMA has not intervened for broader economic objectives such as controlling inflation, maintaining competitiveness or regulating the amount of FX reserves, as these are amply addressed by fiscal measures rather than FX intervention in a pegged exchange rate regime, which is the economy's nominal anchor.





Source: Reuters



Source: IMF/IFS

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