Foreign exchange intervention in Saudi Arabia

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1. Introduction

Saudi Arabia has a fixed exchange rate regime, with the riyal pegged to the US$. The dollar/riyal exchange rate has remained fixed at 3.75 since June 1986. As foreign exchange is predominantly earned by the government, the Saudi Arabian Monetary Agency (SAMA) provides the foreign exchange needs of the private sector by selling dollars against Riyals to the domestic banks.

Typically, speculation against the riyal tends to be in the forward market (due to its off-balance sheet characteristics) in times of oil market weaknesses combined with falling foreign exchange reserves. SAMA intervened in the forward foreign exchange market on two occasions - August-December 1993 and July-September 1998.

2. Macroeconomic considerations

As a resource-based economy, Saudi Arabia's reliance on oil revenues for budget formulation is quite pronounced. Oil revenue constitutes about 75% of total government revenue. It may be noted that the oil sector's contribution to GDP is about 35% and the non-oil sector's (private sector and government) about 65%. Saudi Arabia's nominal GDP growth averaged 5% pa and the cost of living index about 1% pa during the 1990s. The current account balance of payments position has turned positive since 1999, with noticeable surplus build-up lately both in absolute terms and as percent of nominal GDP. The government's commitment to pursue prudent fiscal policy, combined with better oil revenues in 2003 and 2004, resulted in budget surpluses in 2003 and 2004, which has been helpful in paying down debt.

The fixed exchange rate regime has worked well in Saudi Arabia due to the country's foreign currency receipt and payment pattern and the mandatory 100% currency backing by foreign exchange reserves. The currency backing factor puts a ceiling on currency in circulation (it cannot exceed foreign exchange reserves). SAMA foreign exchange operations are conducted within the confines of the regime attributes. Forward intervention in defence of the domestic currency could create vulnerability for countries with excessive short-term foreign currency liabilities and a weak banking system. Saudi Arabia's net creditor position and a strong banking system have been supportive in curbing sporadic forward exchange rate volatility and stabilising the market. In the event of forward intervention, SAMA's outstanding forward contracts with counterparties would settle only when they made payments in riyals to take delivery of their forward dollar purchases. As SAMA has full control on the supply and availability of riyals, short riyal sellers would find it both difficult and costly to honour their part of the commitment.

3. Governance and motives

SAMA chooses the foreign exchange regime in consultation with the government but foreign exchange intervention is carried out at SAMA's discretion within the confines of the exchange rate regime. SAMA has operational and goal independence. SAMA's foreign exchange intervention has been infrequent and goal-specific, ie maintaining exchange rate stability and preserving financial stability. Accumulation of foreign exchange reserves via foreign exchange intervention has not been a policy objective.

As for Riyal exchange rate adjustments against the dollar, they are initiated by SAMA, coordinated with the Minister of Finance and endorsed by the Head of the Council of Ministers. During the 1970s, frequent dollar/riyal exchange rate adjustments were made within the technical framework of the

±7½% margin relative to the riyal's parity of 4.28255 against the SDR, expressed in dollar terms. The margins were suspended on 22 July 1981 to avoid having to devalue the riyal beyond the margins for technical reasons as the dollar kept on rising against the SDR during the first half of the 1980s.

4. Causes of speculation

They are listed below in order of importance and interconnections:

- Falling oil prices and oil revenue
- Falling foreign exchange reserves
- Balance of payments considerations
- Negative press
- Real effective exchange rate
- Contagion effect

During the first half of 1986, speculation against the riyal was triggered by a combination of lower oil prices, widening budget imbalances, falling foreign exchange reserves and a deteriorating balance of payments position. Against these macroeconomic odds, Saudi Arabia devalued the riyal in June 1986 from 3.65 to 3.75 to the Dollar. The small devaluation of the riyal by 2.7% against the dollar was meant to signal to the market that balance of payments considerations warranted devaluation. In fact, the riyal's devaluation against major floating currencies has been much higher by virtue of its peg to the dollar, which was on the course of a sharp downward correction during the mid 1980s.

During 1993, negative press about Saudi Arabia's twin deficits (budget and balance of payments) and falling foreign exchange reserves in the aftermath of the Gulf War caused speculation against the riyal. The situation did not warrant riyal devaluation but a timely intervention in the forward market.

During 1998, speculation against the riyal was linked to oil market weakness following the Asian market crisis and its implications for global growth. Exaggerated movements in forward prices warranted intervention in the forward market.

In all the above cases, the oil market weakness has been a catalyst for speculation. This is because of a misconceived perception that a devaluation of the riyal would result in higher revenue (translation effect). Typically, the translation effect is offset by the transaction effect in Saudi Arabia's open economy. Foreign exchange operators/speculators are short-term punters seeking to benefit from their short riyal positions in the event of a devaluation. They mistakenly conceive that a riyal devaluation raises government revenues and a riyal revaluation results in losses to government on its (a) foreign exchange reserves and (b) riyal revenue derived from oil sales in dollars. It may be noted that translation effect in respect of (a) is accounting and not economic, as higher riyal revenues via currency devaluation are largely offset by the higher cost of imports. Translation effect in respect of (b) is relevant to the extent of net domestic expenditure. There is no exchange effect on direct government expenditure incurred abroad. The component of government expenditure which is exclusively in riyals (payrolls and purchases of goods and services in the local market) is to a certain extent offset by exclusively riyal revenues. A depreciating riyal would inevitably increase the riyal cost of any foreign exchange component of domestic purchases made by the government. It follows that any gains to government revenues in riyal terms from a devaluation of the riyal against the dollar are rather illusory unless justified by macroeconomic reasoning/balance of payments considerations.

5. Intervention tactics and their effectiveness

Speculation in the forward market pushes up foreign exchange swap points, resulting in higher interest rates. Domestic banks, being market makers, keep on adjusting their forward quotations for each incremental transaction amount, as they ultimately seek to cover short forward dollar positions by buying dollars from SAMA. The consequent drain in system liquidity exacerbates interest rate rises. Operationally, longer-dated forwards are targeted in anticipation of a riyal devaluation or higher discounts in the intervening period. Speculation, if left unchecked, would lead to market destabilisation and have cost implications for the economy.

SAMA's intervention policy is to intervene in foreign exchange markets on a discretionary, rather than a systematic basis, and only in exceptional circumstances to counter disruptive short-term movements in the riyal money market. SAMA's intervention may be characterised as both passive and active. In terms of passive intervention/foreign exchange operation's, SAMA keeps on providing spot dollars to the market regularly to meet the private sector's foreign exchange requirements. Given this set-up and the fact that speculative pressure tends to be in the forward market, active or proactive intervention appears to be appropriate in the forward market. There are concerns in some circles that the leveraging factor in the forward market could pose a serious problem for the authorities in honouring their commitments, and subsequently forcing them to devalue or float the currency. This argument holds for overvalued currencies vulnerable to unsustainable capital inflows (eg the Asian financial market crisis of the late 1990s).

SAMA's intervention tactics included gathering relevant information from the domestic banks, such as size of open positions, origin of transactions and volume of trading. SAMA conducted both direct and indirect (via agents) intervention and let the market know about it ex-ante. SAMA's experience has been quite positive in smoothing disruptive market movements and curbing volatility in forward pricing through small-sized forward intervention.

SAMA intervened in late 1993 and Q3 of 1998 when the dollar/riyal interest rate differential ranged between 1 and 2%, as opposed to ¼ to ½% in normal times. At times, forward intervention was backed by money market intervention in the form of liquidity injection through deposit placements and foreign exchange swaps to make a pronounced effect in lowering swap points. Intuitively, if intervention yielded a profit, it would reduce exchange rate volatility, and if it entailed losses, it would be an additional source of exchange rate instability. On both occasions, SAMA's modest intervention totalling US$ 655 m in 1993 and US$ 820 m in 1998 worked in stabilising the market (ie achieving the ultimate objective). This indicates unsustainability of speculative action against economic fundamentals underpinning the currency.

6. Cost of speculation

As Saudi riyal interest rates track US dollar rates due to the exchange rate peg, it is initially inexpensive to speculate against the riyal (the narrow interest rate differential means a small forward premium for the Dollar). Generally, higher interest rates are seen as a necessary consequence of the defense against speculation.

Arguments in favour of interest rate support might sound reasonable to some extent, but the authorities' prolonged indifference could have cost implications for businesses and economic activity. Excessive volatility in market conditions and exchange rate overshooting would warrant official intervention to steady the foreign exchange market and manage domestic interest rates. In fact, interest rate support for the exchange rate or interest rate penalty for speculators could be short-lived unless accompanied by sound macroeconomic fundamentals.

In Saudi Arabia, the cost of defending the peg in 1993 and 1998 was insignificant to the overall economy judging by the small size of intervention and the short period of volatility. This has partly to do with the absence of hot money inflows and the sound banking system. Though profitability from foreign exchange intervention was not an objective, it resulted nonetheless when forward contracts were liquidated.

7. Domestic implications

The government is the major source of foreign exchange supply, being the sole recipient of oil revenue. Operationally, SAMA's routine sales of dollars to the domestic banks are meant to meet the private sector's commercial and financial demand for foreign currencies. Under normal circumstances, foreign exchange operations have no discernible effect on money market conditions. In the event of excessive foreign exchange outflow for speculative or event-specific reasons, there tends to be an imbalance in system liquidity, causing interest rates to rise. However, application of liquidity instruments, such as repos and foreign exchange swaps, has been instrumental in addressing money market disequilibrium to a large extent. Given the steady supply of foreign exchange to the private sector through the domestic banks, sporadic speculation against the riyal has been in the forward market. SAMA's foreign exchange intervention in the forward market did not have to be sterilised, as forward intervention is a less costly means of conducting sterilised intervention.

8. Conclusion

SAMA's intervention in the light of the foregoing can be summed up as follows:

1. SAMA succeeded in breaking the momentum by "leaning against the wind" (acting against the basic trend which is more relevant in the case of managed currencies) and stabilising the market.
2. The profitability criterion (used for measuring success or failure) was satisfied.
3. From a longer-term perspective, forward foreign exchange intervention might not lead to a drastic drain of reserves, given SAMA's control on the supply and availability of riyals.
4. Finally, cognisant of the fact that there is no alternative to fostering sound monetary and fiscal measures to steer the market in an orderly manner and maintain public confidence in the currency, Saudi Arabia paid close attention to macroeconomic stability (including the exchange rate) through fiscal adjustments reflecting the revenue pattern and through avoidance of foreign currency borrowing to finance the budget deficit.

Appendices
(tables and graphs)

a) US$/riyal (SAR) official exchange rates

b) Current account balance

c) Real effective exchange rates

d) US$/SAR spot rates and swap rates

Graphs are self-explanatory showing pre- and post-intervention price movements.

US$/SAR official selling rates

	Rate	% Change
End December 1960	SAR 4.50	-
End December 1971	4.145	8.5
End December 1973	3.56	16.6
End December 1975	3.54	0.5
End December 1977	3.50	1.0
End December 1978	3.30	6.1
End December 1979	3.37	–2.1
End December 1980	3.33	1.2
End December 1981	3.42	–2.6
End December 1982	3.44	–0.6
End December 1983	3.50	–1.7
End December 1984	3.58	–2.2
End December 1985	3.65	–1.9
End December 1986	3.75	–2.7

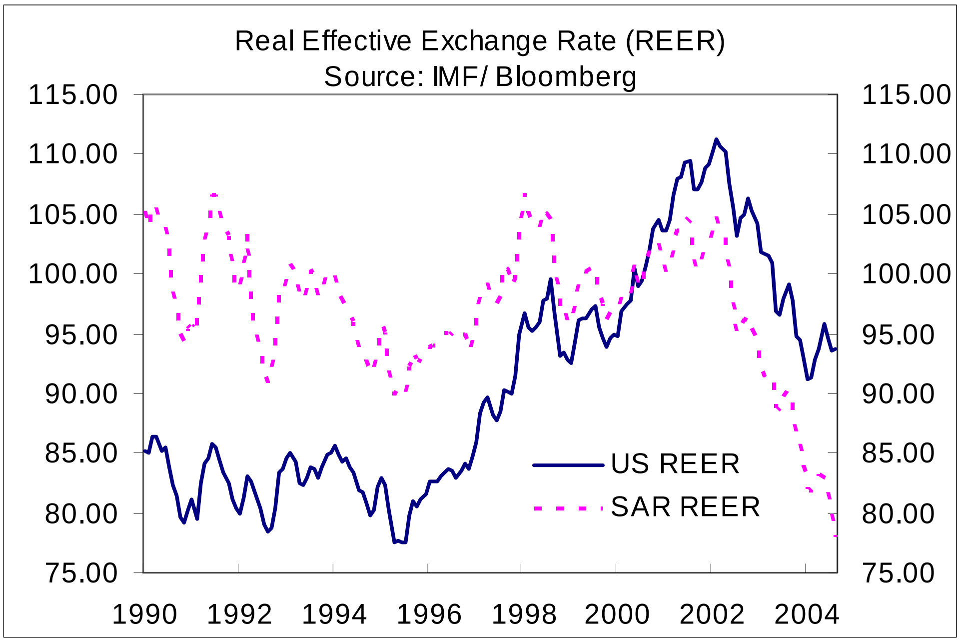
Current account balance

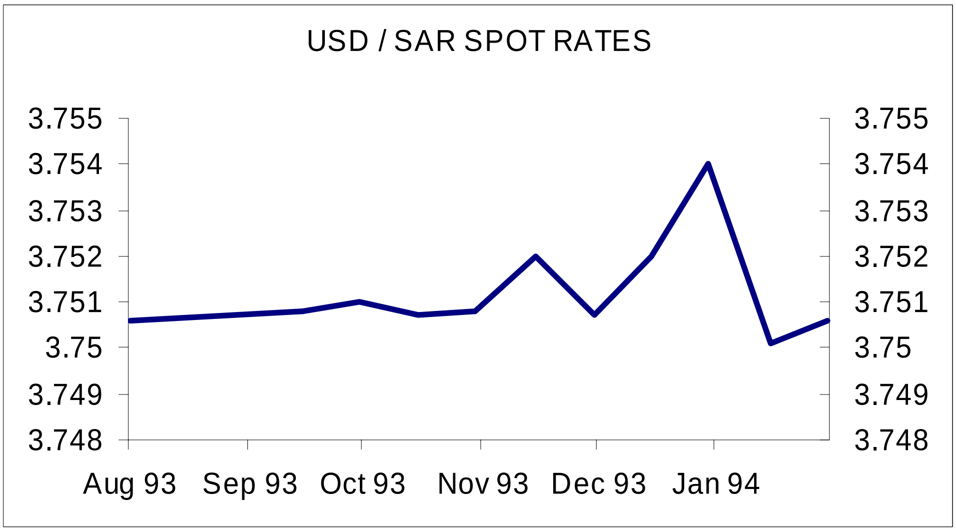
(in SAR billion)

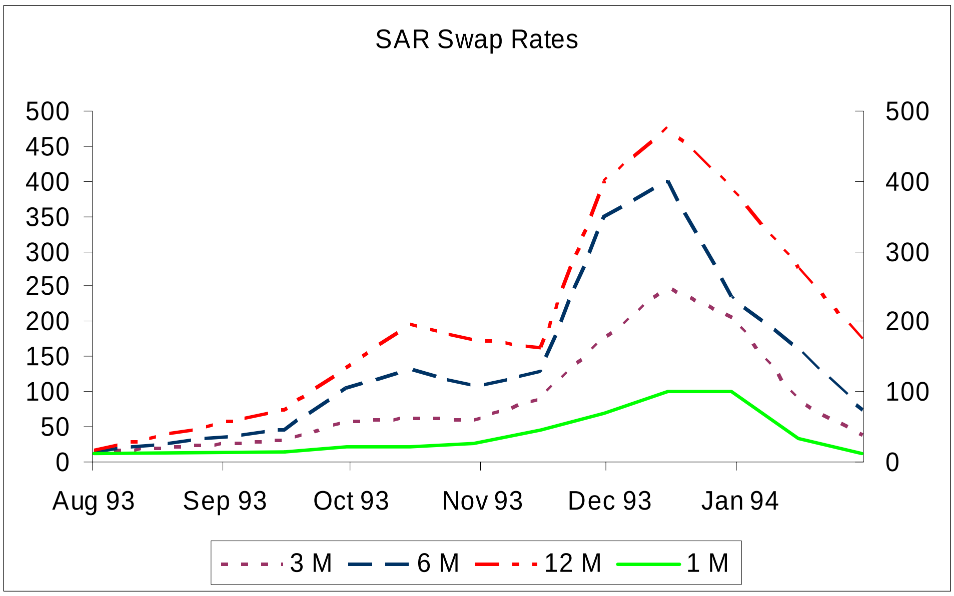
	Trade account	Services and transfers	Current A/C balance	Current A/C as % of GDP
1991	80.8	–184.4	–103.6	–21.1
1992	74.6	–141.0	–66.4	–13.0
1993	61.4	–126.1	–64.7	–13.1
1994	79.3	–118.6	–39.3	–7.8
1995	90.9	–110.8	–19.9	–3.7
1996	131.9	–129.3	2.6	0.4
1997	128.1	–127.0	1.1	0.2
1998	41.9	–91.2	–49.3	–9.0
1999	93.3	–91.7	1.6	0.3
2000	185.8	–132.2	53.6	7.6
2001	146.9	–111.9	35.0	5.1
2002	159.9	–115.4	44.5	6.3
2003	229.4	–118.1	111.3	13.8
2004[e]			193[e]	20.7[e]

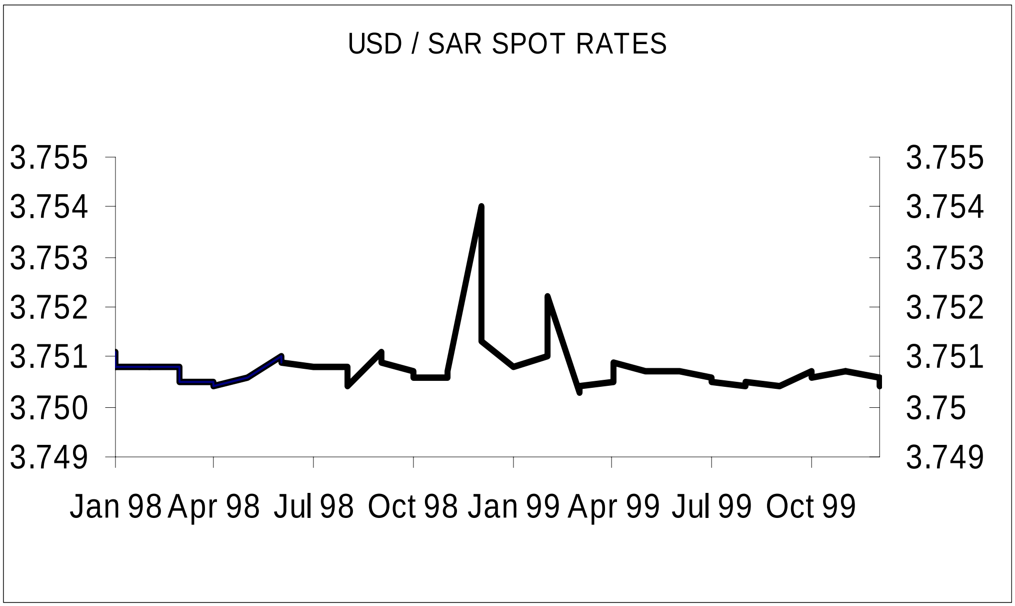
Exchange rate: SAR 3.75 per US dollar since June 1986.

Source: SAMA Annual Reports.


Real Effective Exchange Rate (REER)
Source: IMF/ Bloomberg
115.00
110.00
105.00
100.00
95.00
90.00
85.00
80.00
75.00
1990
1992
1994
1996
1998
2000
2002
2004
US REER
SAR REER


USD / SAR SPOT RATES
3.755
3.754
3.753
3.752
3.751
3.75
3.749
3.748
Aug 93
Sep 93
Oct 93
Nov 93
Dec 93
Jan 94


SAR Swap Rates
500
450
400
350
300
250
200
150
100
50
0
Aug 93
Sep 93
Oct 93
Nov 93
Dec 93
Jan 94
3 M
6 M
12 M
1 M


USD / SAR SPOT RATES
3.755
3.754
3.753
3.752
3.751
3.750
3.749
3.755
3.754
3.753
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3.75
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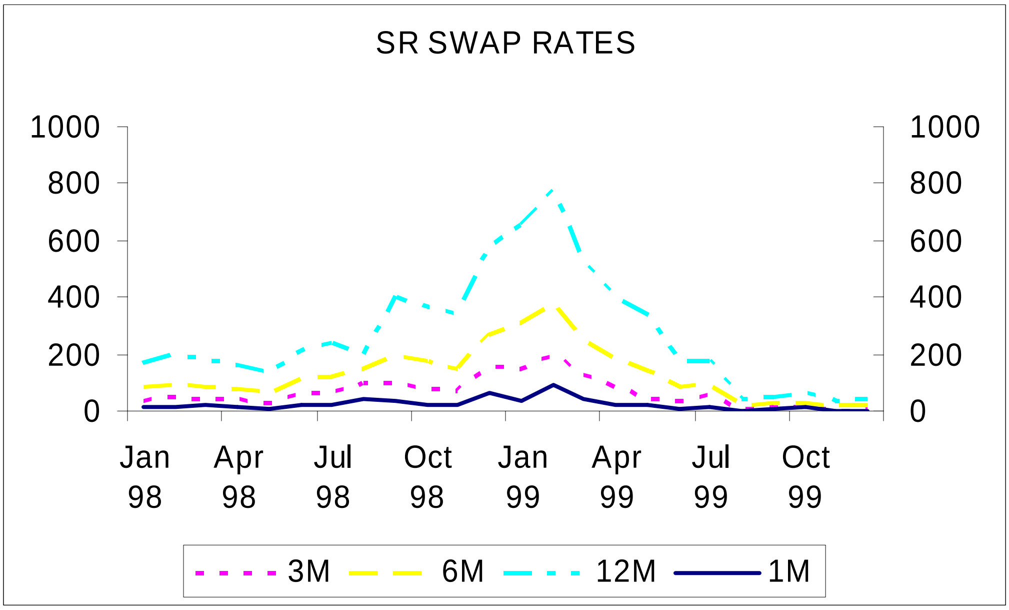
Jan 98 Apr 98 Jul 98 Oct 98 Jan 99 Apr 99 Jul 99 Oct 99


SR SWAP RATES
1000
800
600
400
200
0
Jan 98
Apr 98
Jul 98
Oct 98
Jan 99
Apr 99
Jul 99
Oct 99
3M
6M
12M
1M