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Today I will speak on the macroeconomic policy framework for Saudi Arabia. And I would start out by saying since the theme of this conference is really or this panel of this conference is on boom and prosperity. I would like to emphasize at the outset that no sustainable development can be achieved without a credible, sustainable transparent predictable macroeconomic framework. Boom can not achieve prosperity if we do not have such macroeconomic framework that business people, investors, and government officials can understand and use as the underpinning of their decisions whatever policies of structural adjustment will fare or income distribution can be delivered effectively, none of that can be delivered effectively without such a framework so what I will be trying to paint this morning is the macro economic framework that underpins our policies at the central bank and of course the ministry of finance when it comes to physical policy. So this is really what I wanted to pre-amble my talk this morning. It is my pleasure to be here today, again with the Jeddah economic forum to explain how macroeconomic policy works in Saudi Arabia, currently there are some calls for a reevaluation of the riyal against the dollar or even for a move away from the dollar link, it is claimed that this would reduce inflationary pressures and would allow us to thwart credit expansion and the high level growth of money supply. The complexity of exchange rate management in an oil based economy, and I think this is very important you heard Mr. Greenspan talking when he was asked a question about the flexible exchange rate and he said yes in a diversified economy that would be the suitable one and therefore the assumptions underpinning whatever central bank or government will decide has to be based on the objective conditions prevailing the economy not in what we think should be prevailing but what actually is prevailing in an economy. The complexity of exchange rate management in an oil based economy cannot be oversimplified or based on the standard textbook case. In practice a change in exchange rate policy would not have all the benefits claimed I could simply point to the experiences of our GCC neighbors. For instance, Kuwait has moved away from the dollar peg but inflation has not slowed again if the dollar link rather than rapid growth is the reason for high inflation, then why do inflation rates vary so much around the gulf, is it simply coincidence that inflation is highest in Qatar?, the fastest growing economy in the GCC? But it is my belief that

if our macroeconomic policy is clearly explained, and I hope that I could do that this morning, which is a tall order. Many critics will understand the complexity of the situation, and why there are no easy answers. The simple textbook case for revaluation takes the model of an economy which has an export and a domestic sector and a fixed exchange rate. Let us assume that export growth has been rapid and there's a surplus on the balance of payments. Rising profits and wages mean that growth expands into the domestic sector as consumers spend more with the result that inflation goes up, so the authorities revalue the currency to tackle inflation, revaluation makes imports cheaper and exports less competitive, imports grow and exports fall the surplus on the balance of payments declines, the affect of revelation on inflation comes in two ways. The first is the effect from import prices and this is very small, the extensive economic literature on pass through effect of exchange rate changes to local prices shows that only a small part of any change in the exchange rates actually feeds through to the consumer price index, this is because the foreign export and the local importer adjust their profit margins to try to keep their market share, in practice pre-evaluation reduces inflation by slowing economic growth and so easing demand pull pressure. It slows down the export sector by reducing foreign demand for exports because they cost more in foreign currency, wages and profits in the export sector fall, this feeds through to the domestic sector and the demand pull pressure which reduce the inflationary impulse begins to reverse an inflation comes down again. Now let me apply this simple model to the situation in Saudi Arabia. The economy has essentially one export, oil. A revaluation of the riyal would have no effect on the demand for oil, the price of oil is not governed by the dollar riyal exchange rate and the revaluation of the riyal would not make Saudi Arabia's oil more expensive to buy our exports of oil would not fall as a result of the revaluation and our economic growth would therefore not be effected. The only effect of the revaluation would be on import prices and the pass through to lower consumer price inflation would probably be very small. Saudi consumers would feel wealthier as a result of the revaluation; vacations abroad for instance would certainly become cheaper if consumers spent more at home as a result inflation could very well go up. We can now see why a textbook approach to revaluation does not work in the case of an oil exporter, this is in contrast to India and China they export a wide variety of goods which compete in world markets on the bases of relative prices. In the Indian and Chinese cases a rise in the currency makes their exports less

competitive so there's a direct effect which slows down the export sector thus dampening growth and inflation. In the Saudi case, it is world demand for oil that drives the economy and this is an exhaustion factor. The evidence of many years shows that the growth of the Saudi economy is strongly linked to world demand for oil. What this means is that the exchange rate policy is not in our case a very effective tool for controlling growth and inflation. The most powerful macroeconomic tool at our disposal is counter cyclical physical policy not exchange rate policy. It is by adjusting our physical balance that we can control the effect that oil exports have on growth and inflation and so smooth out the peaks and troughs in our economy that are caused by changes in the world demand for oil. When oil revenues are low we spend more than our income, or foreign exchange reserves are rundown and the government has a budget deficit, when the oil revenues are high as it is the case currently we spend less than we earn foreign reserves go up and there's a budget surplus which is used to pay back government debt. In other words, government spending and varies by much less the changes in our oil income, and so this stabilizes and smoothes out the economic growth path. Ladies and gentlemen, what would happen if Saudi Arabia did not have the counter cyclical physical policy? This would be a situation in which we spend all the oil revenue as we receive them and never built up foreign reserves. When the oil price was high the economy would grow rapidly, but when the oil price was weak government spending would have to fall and there would be a severe domestic slowdown or even a recession. In other words we would be running a pro cyclical physical policy which has passed on to the domestic economy all the unpredictable volatility and the vagaries of the oil market. I do not need to do on the consequences for inflation and consumer confidence if this policy were followed there would be uncontrolled inflationary boom and euphoria in the upswing and depression and deflation in the downswing such an approach would discourage the long term investment on which the future sustainable growth of the economy depends. A more sensible approach is the one that is actually followed to try to stabilize the domestic economy by running a counter-cyclical while physical policy. In our monetary policy the anchor is the exchange rate which has been stable against the U.S. dollar since 1986. Just imagine what would have happened had we had an exchange rate policy that devalues the riyal when oil revenues were low? And are revalued when they were high as currently? This would essentially have a similar macroeconomic effect to running a pro cyclical

physical policy. Evaluation will take the purchasing power out of the economy at just the moment when government spending was falling and would not increase foreign income from oil which comes in as U.S. dollars. Revaluation would exentenate the inflationary boom side of the upswing by increasing domestic demand at a time when government spending was already rising rapidly, because we take a long term view that looks through the cycles in the oil market both physical and monetary policy have the effect of dampening down the impact of oil price volatility on domestic economic development. I have mentioned that a move in the exchange rate would operate differently in Saudi Arabia than in China and India because of the lack of a feedback mechanism into the export sector meaning oil here in Saudi Arabia. A change in our exchange rate policy would not have a positive effect in dampening the economic cycle; on the contrary it would exacerbate booms and slums by its impact on the propensity to import. The evidence from history is that commodity prices are impossible to predict, the IMF has found little evidence of a consistent shape to the cycles in commodity prices the probability that a boom in a commodity such as oil will end is independent of how long the duration of boom has been going on for. Technically for those of you who are technical, this is known as the nonexistence of duration dependence. High oil prices could end at anytime. in the IMF's own words, and I quote "if market participants do not take account of the nonexistence of duration dependence there's a danger that they may misperceive the nature of commodity price cycles, they mean mistakenly believe that because prices have been in a boom period for a long time that there is a new paradigm so that cycles are no longer relevant" and in this region we know well that the oil price is the most volatile of all major commodities. It is important to make this point because many commentators speak of a new paradigm in which oil prices stay permanently high a number of reasons are put forward for this belief some argue that world oil reserves have peaked and are in danger of running down so there's an impending supply problem, others talk of ever rising demand for oil from the emerging age in economies specially India and China as they seek to emulate energy rich lifestyles of developed economies. But the assumption that this time things are different is heard at the top of every peak in oil prices as a result in previous episodes oil exporters continued to spend at a high rate years after oil prices had started to fall again. High levels of government spending went on longer after it was clear in retrospect that the assumption that high oil prices were

permanent was a faulty one. The price of oil is so unpredictable that even with countercyclical policies the volatility of the GDP of oil exporters is almost twice as high as that of developed economies. There will obviously be times when any long-term macroeconomic framework will come under attack, it is perhaps odd that when growth has been so strong we should be pressured to further stimulate consumer spending by revaluing the riyal. On the other hand, some people believe that if we did so inflation would fall; it might although the Kuwaiti evidence is that it would not. But a revaluation would only work by making imports cheaper and if people felt better off as a result and spent more inflation would up, moreover it would damage our other export industries. It is also argued that the dollar link prevent SAMA from raising rates to slow credit expansion, but credit expansion is driven by the strong growth in the economy and the evidence is that raising interest rates in the Saudi situation would not have much effect on consumer or business spending. Interest rate changes operate most powerfully when the consumer has a high ratio of debt to income and Saudi consumers as well as businesses have a slower debt load than consumers and businesses in developed economies. It is better to tackle credit expansion by administrative measures which we are actually doing. I would like now to turn to the debate about de-pigging the riyal from the dollar. About 90% of government spending comes from oil which is priced in dollars, 88 of our export revenues are in dollars, 2/3 of imports are priced and paid for in dollars. these facts mean that any currency basket we might adopt would have to be dominated by the dollar. However, we would have to give up the benefits of the certainty of our exchange rate policy without any commensurate compensation. Adjust in the exchange rate has in our present particular circumstances more capacity to do harm than to do good. Exchange rate policy should be seen as a mechanism to promote stability in the long run by keeping the cost borrowing low and encouraging long-term investment and growth. Macroeconomic changes are far better carried out by physical policy that is through decision of how much of our oil income to spend now and how much to save for future. Finally, like Saudi Arabia India and China have had rapid growth in recent years driven by the growth in exports but they have diversified export sectors which respond to changes in exchange rates for instance, China has been revaluing its exchange rate to move the export sector into a higher value added goods. Again export revenues accrue to the private sector in the first instance, unlike our situation so India and China have to engage in

stabilization to map of the excess liquidity. Saudi Arabia's export are dominated by a single commodity oil price which varies massively and unpredictably. the recent rise of our foreign reserves was not predicted by anybody a few years ago, it is a cyclical phenomenon which is quite different from the circular growth story of India and China. In conclusion, the macroeconomic problem in Saudi Arabia is how to stabilize the inherent and unpredictable volatility which is the result of exhaustions changes in the world's demand for oil physical policy given its predominance in our economy is the effective tool for countercyclical actions monetary policy has its limitations in addressing the issues of inflation deflation and growth indeed altering our exchange rate policy would not help stabilize the economy and moving away from our current long-term policy of a stable exchange rate against the dollar would be more likely to do harm than good. I wish that revaluing or de-pegging where the panacea for inflation or other else a less the dismal science tells us that macroeconomic management is much more complex and does not lend itself to quick fixes, be aware of those who believe in quick fixes.

Thank you very much.