The Evolution of the Saudi Arabian Monetary System *

I. The financial and trading position that Saudi Arabia enjoys today is a major event of the 1970s decade. The base upon which such a position rests is the large foreign (hard) currency earnings and the consequent accumulation of reserves stemming from the export of crude oil. Despite this, management of money, finance and banking in Saudi Arabia still follows the basic rules of the past. In terms of institutions or practices Saudi Arabia in fact lags behind many other less fortunate third world countries.

II. Although a national currency (coins) was issued in 1925, it was not until 1952 that the government decided (upon the recommendation of a team of US advisors) to establish a central banking authority, namely the Saudi Monetary Agency (SMA). Although, since its establishment, the SMA resembled and today resembles a central bank in its functions, it falls short of many traditional functions of a central bank. Contrary to the experience of many third world countries where financial and banking institutions and practices were inherited from the colonial past, the SMA has in fact evolved from earlier government financial agencies and departments which were in charge of collecting government levies and taxes, as well as minting coins.[1] The contrast in this respect with other third world countries is a unique feature of Saudi monetary development and is due to the fact that Saudi Arabia did not have a colonial past, or much European influence during the nineteenth century. Until the advent of the oil industry Saudi Arabia had no domestic or foreign banks.

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[1] Coins have been minted in the Arab world, including what is now Saudi Arabia, since the 8th century.

The main function of the SMA today is the issue of currency. However this was not one of its original functions when it was established.[2] The issue of currency, which was then only coins, was kept as the responsibility of the Ministry of Finance. Until 1960 the Saudi currency in circulation was based on the silver riyal and subsidiary base metal coins. However for a short period of time (1952-1954) the Ministry of Finance circulated a gold coin called the Saudi Guinea, which aggravated existing problems for the Saudi monetary system, because of fluctuations in the value of the two metals in a bi-metalism standard.

The metal standard was costly as well as inconvenient for an economy about to enter into rapid development due to the discovery and the commencement of the export of oil.

However the authorities persevered with the metal standard for religious reasons. Certain religious interpretations bar the use of paper currency on the jurisprudence grounds that trading should be between items of equal intrinsic value. Since paper money does not have intrinsic value it may not be used in the purchase of intrinsic values. The belief that such an interpretation was widely held led the US team of experts to recommend the continuation of the metal standard. Later events proved that such a belief was mistaken. In 1955 an amendment to the original Royal Decree authorised the SMA to issue paper currency as well as subsidiary coins.

The SMA experiment with paper currency started shortly after that amendment. It is ironic that it was for the convenience of pilgrims that the SMA first issued IOVs, or what was known as pilgrims' receipts. Instead of carrying around several kilos of silver while performing pilgrimage, a tiring task in itself, a pilgrim could instead convert his silver riyals into receipts for his transactions during the pilgrimage season. The receipts were fully convertible into silver riyals, but were not legal tender. However, general public acceptability of the receipts was such that they continued to be used outside the pilgrimage season. One cannot fail to draw similarities between the SMA in the 1950s and the goldsmiths of London centuries before.

Encouraged by the general acceptability of the pilgrims' receipts, the government authorised the SMA to increase the issue of receipts to meet the government's borrowing requirement. It also authorised the SMA to withdraw the silver riyal from circulation and place it into the

[2] Saudi Royal Decree, No. 30/4/1406, dated 20-4-1952.

reserves. The increase in the issue of the pilgrims' receipts was so large as to reduce metal reserves from 100% to 25% and to lead to high inflation. Inflation was an entirely new experience for Saudi Arabia. It resulted in a panic exodus of capital (in the form of precious metals) and general loss of confidence. This disastrous SMA experience with paper currency could, in as traditional society as Saudi Arabia was then, have resulted in a reversal to the metal standard. Fortunately for the SMA it was too late for such a reversal. Times had changed to the extent that a return to a monetary system based entirely on coins was no longer feasible.

As money income rose during the 1950s with the expansion of oil exports and because of inflation, greater quantities of silver had to be carried to satisfy transactions. It was estimated then that the monthly wage rate of a low paid labourer in the oil industry weighed 10 lbs of silver. The SMA found difficulties in importing, minting and storing the increasing quantities of silver. There was also the problem of the frequent melting down of silver riyals when the metal value of the riyal was above its nominal value and forging it when the opposite was true.

In 1960 the SMA was authorised to adopt a new currency system consisting of both notes and coins. The riyal note became for the first time legal tender and the monetary standard. Its value in gold was stated and, in accordance with the IMF system, its value was pegged at 4.5 riyals to the dollar.

In order to avoid all possibilities of a repetition of the previous large scale borrowing from the SMA, the new royal decree prohibited the SMA from lending to the government or to any private concern. It strictly specified that reserves should be 100% of the currency issued, made up of gold and foreign currency convertible to gold. The inclusion of foreign currency in reserve for the first time followed the receipts of oil royalties partly in foreign currency and not entirely in gold bullion and sovereigns as before. Reserves were initially held as 50% gold and 50% in foreign currency.

The prohibition which prevents the SMA from lending to the government or private concerns and the 100% reserve requirement are still the basic rules of operation of SMA and have been so since 1960. The only difference now is in the mix in which reserves are held. Gold now represents a much smaller proportion (2%) of much larger reserves. The decline in the importance of gold as a means of international settlement has eventually convinced Saudi Arabia to waive its attachment to gold.

III. The SMA's rules of operation are designed for simple but rigid and inflexible monetary management. However, bearing in mind the financial condition of Saudi Arabia since 1974, it can be argued that such rigid monetary management has not in fact deprived the Saudi economy from the use of much needed instruments. Government annual oil revenue (the main part of total government revenue) has been well above annual government expenditure and because of this reserves of foreign currency have been built up. Oil revenue during the last two years has been well above the domestic economy's absorbative capacity. However the situation was not like this prior to 1974, when Saudi oil revenue was less than 10% of the level it reached in 1980. (It has been falling off recently from the level it reached in 1980). So it might be possible to argue that the Saudi economy, even given the then more limited absorbative capacity than post 1974, could have benefitted from a flexible monetary policy during the 1960s and early 1970s, through government borrowing from the SMA. However, given that the SMA rules of operation had then only recently been established and the still vivid memories of the middle 1950s inflation, such flexibility was not to be had.

The increase or otherwise in currency issued by the SMA was and still is determined entirely by its assets of gold and convertible foreign currency, as can be seen from Table 1.

TABLE 1

CURRENCY ISSUED AND RESERVES 1970-1981

Year	Currency Issued	Reserves: Million Riyals	
		Gold	Convertible Foreign Currency
1970	1,880.2	574.2	1,306.0
1971	2,083.8	574.2	1,508.8
1972	2,201.1	574.2	1,626,8
1973	2,770.0	574.2	2,195.8
1974	3,553.3	546.4	3,006.9
1975	4,920.0	546.4	4,373.6
1976	7,979.2	546.4	7,432.7
1977	17,685.4	546.4	17,139.0
1978	21,923.5	756.3	21,167.2
1979	26,225.7	756.3	25,469,4
1980	29,377.2	756.3	28,620.9
1981	32,024.4	756.3	31,268.1

Source: Derived from the Saudi Arabia Monetary Agency, *Annual Report* 1981, p. 123.

From the above table it is clear that the currency part of the total money supply has increased by nearly eighteen times within a decade. It is also clear that during the second half of the decade currency issued increased at a higher rate than during the first half, responding to the higher rate of growth in government expenditure made possible by still higher oil revenue.

The above table does not, however, show total money supply. The currency part of the total money supply has been falling and represented about 25% of total money supply (M3) in 1981. However of more analytical importance is the rate of growth in currency issue during the 1960s decade in comparison with the 1970s. In 1960 currency issued stood at 697.1 million riyals. It grew to 1880.2 million riyals in 1970, i.e. currency issued within a decade grew by about two and a half to three times. So the growth rate of currency issued during the 1960s represented about 15% of the growth rate of currency issued during the 1970s. However the conclusion to be made concerning the comparative growth rate of money supply during the two decades can only be tentative, bearing in mind that currency represented a higher proportion of total money supply during the 1960s than during the 1970s. Banking during the 1960s in all respects was in its infancy.

The other main function of the SMA is being the government's bank. Various government departments and autonomous agencies deposit funds with the SMA. The latter also receives payments due to the government from foreign and domestic sources. This function was inherited by the SMA from previous government agencies, public as well as private. However, the new and important part of this function is the management of government investment in foreign bonds and currency deposits. To fulfill this part of its function, the SMA relies at present on a group of British and US financial experts seconded by their institutions. So long as the government account with the SMA remains in credit, the SMA will fulfill its function as the government's bank. But it cannot remain so legally if the government's account went into the red.

The recent fall in Saudi Arabian oil revenue might not be reversible in the short or medium term, either because of sluggish world demand for crude oil exports, or a smaller quota for Saudi exports within OPEC, or both. In such a scenario government revenue might fall short of planned government expenditure. To speculate one option would be to sell foreign assets held by the government. These assets are income earnings and increasingly represent an important and stable alternative (to oil exports) source of income. The other option would be to borrow from the SMA. This would require an amendment to the SMA's charter. No foreseen political or social difficulties are likely to impede such an amendment or change in the rules of operation. When this eventually comes about, the SMA will be more in line with other central banks in the world in fulfilling the above two functions.

IV. The third function of the SMA involves its relationship with commercial banks. The SMA is not the bank of the banks in the way that central banks usually are. It is not a lender of last resort. Legally it is not a lender at all. It is not easy to say whether and how much this has affected the development of local corporate banking. Until the early 1960s banks in Saudi Arabia were mainly branches of foreign banks. Local banking, if it can be called that, was no more than family businesses involved in the exchange of foreign currency. Social factors, particularly religious ones, motivated then strongly against normal banking business.

Recently the Saudi-ization of foreign banks through majority shareholding was pursued. Despite this, shares in banks are inaccessible to average investors and remain in the hands of a small number of families of large investors.

The other aspects of the relationship between the SMA and commercial banks are essentially statutory control by the SMA of the operation of the commercial banks. Commercial banks have to deposit their cash reserves with the SMA within the limits specified by the SMA. They also have to obtain a licence to commence business or open new branches. In addition changes in a bank's capital between paid and invested requires the approval of the SMA. Permission from the SMA is also required for the investment of banks in shares and real estate. The SMA finally reserves the right to ban commercial banks from advancing particular loans or undertaking certain commercial activities.

The last function of the SMA is the control of credit. Two of the most important instruments used by central banks to control money supply are not used by the SMA. First it is not involved in open market operations, because there is no money market in Saudi Arabia and if and when it comes about the SMA will not be legally empowered to enter into such a market, as we have outlined above. Secondly, the SMA does not use a discount rate because officially the interest rate is a religious taboo, particularly for public financial institutions. Even if the SMA circumvents that taboo, as commercial banks unofficially do, legally it cannot lend to commercial banks.

What instruments then are left for the SMA to control the money supply? The SMA decides upon the cash reserves to be held by commercial banks. The policy followed by the SMA in this respect relies more on persuasion than on legally binding decisions. The SMA can affect money supply through buying from and selling to the commercial banks and individual foreign currencies. Besides the SMA can have a similar effect on money supply through advising the government to shift its deposits to and from commercial banks so as to affect the latter's ability to advance loans.

V. In parallel with the rapid economic development there has also been an expansion of banking and finance institutions in Saudi Arabia. However money, banking and the basic rules of finance are essentially the same as they were twenty-five years ago when the Saudi society and economy were stagnant.

The SMA's rules of operation today in an open and affluent economy are no different from what they were then. It still provides the medium of exchange with limited control over credit in the economy. The reasons for this are historical, social and the rather fortunate financial position of Saudi Arabia, which has made simple, indigenous and unique rules and policies of monetary management still functional.

Still there has been a slow evolution of new rules and policies and an equally slow adaptation of old ones. However, what is more important is the circumvention by banks of the religious taboo concerning interest payments through the use of a variety of names and labels, such as "administrative charges" and "sharing in profits".

Contrary to other third world countries, including neighbouring ones, Saudi monetary management is unique. It imported little if anything that could be obtained from the experience of the outside world. Instead it recognised historical and social factors as given constraints within which the gradual evolution of an indigenous money and banking system is still maturing.

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