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Pre- versus post-crisis central banking in Qatar☆

Elsayed Mousa Elsamadisy, Khalid Rashid Alkhater, Syed Abul Basher *

Department of Research and Monetary Policy, Qatar Central Bank, PO Box 1234, Doha, Qatar

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Abstract

In the years before the global financial crisis of 2008–2010, Qatar experienced a huge build-up of liquidity surplus in the banking system, mainly driven by surging net capital inflows. This paper identifies various sources of interbank liquidity in Qatar and discusses the various implications of structural primary liquidity surplus for the money market in particular and the economy at large. The paper attempts to evaluate the Qatar Central Bank policy making and conduct during the pre- and post-crisis periods within a framework of the Austrian monetary overinvestment theories, and concludes that the central bank had forcibly committed several forced monetary policy mistakes, which resulted in a breakdown in the interest rate channel of the monetary policy transmission mechanism. This led to the inability of the central bank to control the interbank interest rate and to an accelerating inflation rate during the pre-crisis years. In contrast, a dramatic change in the central bank's monetary policy framework and a deliberate monetary policy mistake on behalf of the central bank resulted in a restoration of the interest rate channel of the monetary policy transmission mechanism, stabilization of the interbank interest rate close to the central bank's policy rate and a sharp deceleration in the inflation rate in the post-crisis period. The paper concludes by offering brief policy recommendations.

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* Corresponding author. Tel.: +974 44456490; fax: +974 44416771.

E-mail addresses: elsayed.elsamadisy@gmail.com (E.M. Elsamadisy), alkhaterk@qcb.gov.qa (K.R. Alkhater), syed.basher@gmail.com (S.A. Basher).

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1. Introduction

The Gulf Cooperation Council (GCC)[1] countries have emerged as one of the most financially liquid regions in the world on account of the unprecedented economic boom triggered by high oil prices during the last decade. The current account balance of the GCCs went up from US$32 billion in 2001 to US$256 billion in 2008, compared to the members of the Organization of Petroleum Exporting Countries (OPEC),[2] whose current account rose from US$19 billion to US$184 billion over the same period. Fig. 1, adapted from Peeters (2011), illustrates the composition of gross flows of the GCC's current and capital account over this period. As Fig. 1 shows, total portfolio investment outflows outstripped total portfolio inflows, reflecting the accumulation of hydrocarbon revenues by the GCC countries. Since 2003, government current spending has risen cumulatively by 58%, mainly reflecting rising wages and subsidies (International Monetary Fund (IMF), 2008). A policy mix of an expansionary fiscal stance and an easy monetary stance (imported via fixed exchange rates) resulted in growing economic deficits to be monetized by the central banks.

The incidence of a liquidity surplus, in its broader sense, has been a common phenomenon observed across the GCC region during oil-price booms. The GCC's high surplus led to strong domestic aggregate demand. Over a span of six years, the average annual growth in private consumption jumped from 8% in 2003 to over 24% in 2008, with Saudi Arabia exhibiting a nearly five-fold increase, and Oman and Qatar both presenting a four-fold increase. Gross capital formation increased from about 35% of the non-oil GDP in 2003 to about 48% in 2007 (IMF, 2008). Investments were broad-based in all countries except the UAE, where they were more concentrated in construction (Khamis et al., 2010). Robust aggregate demand (including exports) led to strong economic growth: over the 2003–2008 period, GCC countries grew at an annual average real rate of 7%. This impressive economic performance has been accompanied by a general increase in consumer prices. Average headline inflation jumped from 1.5% in 2003 to 10.6% in 2008, with considerable variation in the level and volatility of in inflation rates across the six countries.[3]

Being no exception within the GCC, Qatar has witnessed a gradual accumulation of net capital inflows since mid-2000 owing to hydrocarbon revenues, geo-political and geo-economic developments. In particular, accumulation of foreign reserves on the asset side of the Qatar Central Bank's (QCB's) balance sheet can be traced back to the fraction of hydrocarbon revenues injected into the domestic economy via (i) the government budget; (ii) net private sector's foreign borrowing; (iii) foreign direct investment (encompassing the cash portion of hydrocarbon-related investment and real estate purchase); and (iv) net short-term foreign portfolio investments (including stocks, bonds, bank deposits, etc.). Moreover, Qatar witnessed a further remarkable surge in foreign currency inflows beginning in late 2007, due to a speculative revaluation attack on the Qatari Riyal (QR). Such net inflows resulted in surges in the economic deficit[4] that the QCB had to monetize. This, in turn, resulted in the accumulation of abundant QR liquidity on the liabilities

[1] The GCC countries include Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates (UAE).

[2] These include Algeria, Angola, Ecuador, Iran, Iraq, Libya, Nigeria and Venezuela. Among the GCC countries, Kuwait, Qatar, Saudi Arabia and the UAE are OPEC members. The authors' calculations are based on the *World Economic Outlook Database*, April 2011, International Monetary Fund.

[3] All numbers, unless otherwise stated, are authors' own calculations based on national sources.

[4] By economic deficit, we mean the proportion of government expenditure financed by hydrocarbon revenues minus the net private sector's transactions compared to the rest of the world.

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