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In This Issue

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THE MIRAGE OF MONETARY POLICY - THE TRILLION-DOLLAR LIQUIDITY PUZZLE

By Dr. Vinodh K Natarajan

Every one of us may get a chance to witness a rare event once in our lifetime. The COVID-19 pandemic has provided a chance to economists and academicians to witness two never-seen-before situations. First, world-wide central banks were relaxing the monetary policy and governments were pumping billions into the economy. This is a rare combination of having a relaxed monetary policy and fiscal policy being so loose. This phenomenon worked wonders in mitigating the economic consequences of the COVID-19 pandemic crisis.

Before COVID-19, countries were facing strong economic growth fuelled by the trillions of money pumped into the word economy which started almost a decade ago i.e., post 2008 global financial crisis. During COVID-19 pandemic, countries have induced into the system billions of dollars to provide benefits to the people. Post the severity of the pandemic, countries continue to pump in billions of dollars to stimulate growth and create employment.

This has led to the second never-seen-before phenomenon wherein the world economy is currently witnessing excess liquidity amount to trillions before COVID-19, and trillions more after COVID-19.

The existence of this money in the economy amounting to trillions of dollars is currently pushing inflation across the world. The talk of the popular markets and thinkers is that this inflation is war driven and induced by pent-up demand or supply side shocks. In some ways supply side shocks have impacted in creating inflation as oil prices have risen due to the war. Many developing countries are huge importers of oil, and oil prices have been going up. This has led to the increase in input costs leading to a rise in the price of essential commodities. Countries where the government provides many social benefits for meeting the basic needs of individuals have been mitigating the effects of inflation in a small way.

But the current inflation is not entirely war driven. This is partly driven first by money pumped into the economy. This is based on the traditional notion of monetarists that pumping money into the economy will control inflation. Countries during the COVID and post COVID pumped excess liquidity into the economy. The pumped money in some ways did reach the poor or the middle-income consumer. But in most cases the excess liquidity was absorbed by the affluent or investment class who used this excess liquidity for investments rather than for consumption. This has led to increase in market valuation in shares, real estate and gold which does have effect on consumer process or leading to any actual economic activity. Creation of manufacturing or job creating activities is fundamental in stabilising and pushing the economic growth of a country.

Another reason for the rise in inflation is that post 2021, there is a bounce in economy and there is intense competition for labour (should separate with coma) and because of that wages are being driven up. This, combined with supply-side shocks from COVID has resulted in pushing inflation.

Currently world over human behaviour or expectations psychology can be termed to be more rational than adaptive. This shift in expectations can be attributed partly to the advancement of technology and proliferation of news into every corner of the world in a short time. News travel faster than ever before. This tends to make people more rational in their thinking. This pushes people to start buying to avoid inflation which in turn will accelerate inflation. Now brings us the very important question of how the world is trying to tackle this rise in inflation. The tools or mechanism that can influence inflation are fiscal policy, monetary policy and global variables that are not under the control of any one country.

Monetary policy is where you control inflation and control variables that can contribute to inflation. Post Second World War, European central banks act too quickly and increase interest rate when there is sign of rising inflation rate. Currently central banks were too slow in increasing the interest rates as they felt inflation is happening due to supply side constraints rather than low interest rates or lack of economic growth. The same scenario was built in 2003 where in the Federal reserve decreased interest rates when there was excess liquidity inbuilt into the world economy. This was the start the bubble which resulted in the 2008 financial crisis.

The same scenario is currently prevailing. Raising interest rates is the most important thing to be done in the current scenario. In fact, higher interest rates will not take away the liquidity from the markets but will stabilise the excess liquidity amounting to around 5 trillion dollars in the world markets. Central backs have raised the interest rate but is too late, we have wait and watch how governments enact the fiscal policy is in the next couple of years to address the supply side shocks and avoid a situation of stagflation.

Fiscal policy is another mechanism which is always used as a medium-and long-term instrument to impact inflation. In other words, it is a growth-oriented stimulant which can create jobs and stabilise the inflationary effects. So, governments across the world are now spending huge on activities that will generate jobs. Intent to create jobs and actual job creation are too different things. Governments who have the administrative capability and the execution capacity of delivering on the intent of fiscal policy will tide over the inflationary pressures and will be in better position in the medium or long term.

Bahrain is in a better positioned state than most of the world countries. The Central Bank of Bahrain have raised the interest rates. The government has both the administrative capabilities and the execution capacity. In fact, the execution capacity of the Bahrain government can be ranked as one of the best in the world.

But a word of caution is to be mentioned. Most GCC countries have shifted the tax policy to indirect taxation and into point-of-sale taxes and other taxes. This is a very good as the governments of the GCC has shifted their focus on generating revenue from non-oil based economic activities. World over this taxation policy has gained lot of popularity among fiscal policy makers as revenue generated for the governments are high and the point-of-sale taxes hits everyone irrespective of their income bracket.

This is good if the per capital income of the country is high and it has a strong currency and inflation is low. Yes, Bahrain as a country has the high per capita income and a very strong currency. If the current inflation rate is kept at normal levels, then in the long term the country will experience a stable and vibrant economy not hampered by inflationary pressures and loss of employment and will reap the benefits of point-of-sale tax.

Having said this in the long run fiscal policy makers must come with other innovative way of increasing the government revenue and reduce the dependence on point-of-sale tax. This is because point of sales tax has more economic benefits than social benefits. Although countries provide numerous social benefits in many other forms, following a regime of point of sales tax will work if the above three conditions are met. The moment there is disruption in exchange rate, inflation and per capita income falls then governments will face huge shortfall in revenue generation.

An innovative suggestion is transaction taxes, but this needs to be debated and properly studied. Another innovative suggestion is to built progressive taxation into the point-of-sale tax or VAT by adopting a tax refund policy for low-income group people or people having big joint families. This also needs to be studied and debated.

Final word, monetary policy is not redundant but need to be done with caution and be more tuned to use the excess liquidity currently in the system. Most central banks have unprecedented liquidity in their system. Central banks actions must not create too much liquidity in the system which goes into asset or wealth creation rather than it should lead to job creation or consumerism.

Fiscal policy must complement monetary policy in providing avenues for long term job creation. Finally, there is a need for innovative tax policy. I am an ardent advocate of slow and constant growth which is better than accelerated growth in the short run and hitting a stagnant wall in the long run.

QUARTERLY NEWS UPDATE

Local News

BAHRAIN'S GDP GROWTH AT 6.9% IN Q2 2022

Bahrain's economy grew 6.9 per cent in the second quarter of 2022 to record the highest rate of growth in the past 11 years, driven by a strong performance in the country's non-oil sectors that were targeted under the country's economic reform plan.

Data from the Ministry of Finance and National Economy shows non-oil growth was led by the Gulf country's hotels and restaurants sector, which grew 18.1 per cent compared with the second quarter of 2021, state-owned Bahrain News Agency reported on Sunday.

KFH ACQUIRES 97.273% OF AHLI UNITED BANK

The final results of the landmark USD 10.9 billion acquisition of up to 100% of Ahli United Bank B.S.C. (AUB) by Kuwait Finance House K.S.C.P. (KFH) were announced today. SICO BSC (c), a leading regional asset manager, broker, and investment bank (licensed as a wholesale bank by the CBB), acted as Bahrain receiving agent, Bahrain execution advisor, and cross-listing advisor on the deal, which was structured by way of a voluntary conditional offer by KFH to AUB shareholders to acquire up to 100% of AUB's issued and paid-up ordinary shares. The transaction was offered through a share swap at an exchange ratio of 1 new KFH share for every 2.695 AUB shares.

Regional News

SAUDI INFLATION RISES TO 3.1% IN SEPT ON HIGHER FOOD PRICES

Saudi Arabia's inflation rose to 3.1% in September, driven mainly by higher food prices, rents, and the rising cost of utilities, the General Authority for Statistics said on Thursday. Compared to the previous month, the Consumer Price Index (CPI) for September was marginally higher, up 0.3%, it added.

Food and beverage prices rose 4.3% in September, while housing rents were 3.6% higher, pushing the overall increase in housing, water, electricity, gas and other fuels to 3.2%.

QATAR CENTRAL BANK'S FOREIGN CURRENCY RESERVES RISE TO $57.74BLN IN JULY 2022

The foreign currency reserves and liquidity of the Qatar Central Bank (QCB) increased by 2.79 percent to reach QR 211.325 billion in July compared to QR 205.575 billion in July 2021.The figures issued by the QCB Sunday showed that QCB's official reserves increased by the end of July 2022 than last year's by about QR 4.775 billion to reach QR 153.890 billion. This is driven by the increase in the central balances of bonds and foreign treasury bills by about QR 19.522 billion to the level of QR 113.142 billion in July 2022.The reserves consist of four categories: foreign securities, balances with foreign banks, gold, and Special Drawing Rights (SDR), and the State of Qatar's share at the International Monetary Fund (IMF).

QUARTERLY NEWS UPDATE

International News

JAPAN HAS THE LOWEST INFLATION OF ALL MAJOR ECONOMIES

The Bank of Japan (BOJ) has decided to stick to its monetary easing policy amid accelerating global inflation growth. Inflation in Japan is the lowest among major economies, with the Consumer Price Index (CPI) rising 2.8% in August, compared to 8.3% in the US and 9.1% in the EU. Even so, infrastructure costs, such as electricity and gas rates, have increased by more than 20%, and food prices have risen by around 10%. This has come as a big shock to the public in Japan, as the country has not experienced price hikes for decades.

QUEEN ELIZABETH II'S DEATH SLOWED ACTION ON A U.K. ECONOMY ALREADY IN TURMOIL

Inflation has soared to the highest levels since the 1980s, at around 10%, and the nation faces an energy crisis in large part over dwindling Russian energy exports to Europe. The British pound has also been languishing around a nearly 37-year low against the U.S. dollar. And economic growth is another concern—the U.K. has now fallen behind India, becoming the world's sixth-largest economy. The U.K.'s central bank, the Bank of England, has warned that it risks falling into a recession that could last well into 2024.

ROLE OF BEHAVIORAL BIASES IN INVESTMENT DECISION MAKING

by Dr Chithra Suresh & Ms. Savitha Raghavan
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Traditional finance theories assume that investors are rational individuals, and they aim to create optimal portfolios. It also assumes that they have the mental faculties required to process the available information in a rational and unbiased manner. Based on this information they create an optimal portfolio in order to maximise their investment returns at a given level of risk. However, we all know that this is not how the world works in reality. All market participants might not have access to perfect information, or they cannot rationally process all the information and make informed decisions. There are a wide variety of psychological processes or biases which influence the investment decisions made by investors. These biases and psychological processes are explained in behavioral finance which provides a logical explanation for the systematic deviations from rationality exposed by investors. Existence of many of the financial market inefficiencies and anomalies can be attributed to the cognitive biases and emotional biases experienced by the investors.

An understanding of Behavioral economics is imperative for the investors as traditional financial theories were incapable to explain many of the anomalies that transpired in the stock market. For e.g., many a times investors have observed that the price of a stock is totally out of sync compared to certain indicators like book value, EPS, etc., if the efficient market hypothesis is to be believed, such anomalies should not exist at all because the market would auto correct

WOMEN
INCLUSION
COMMITTEE

WOMEN OF THE QUARTER

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Dr. Chithra Suresh is a seasoned trainer and academic practitioner with 20 years of experience in training and coaching. Currently she is working as Senior Lecturer in the Banking Centre of Bahrain Institute of Banking and Finance (BIBF). She has done her PhD in Economics from India, where her study focused on bank efficiency and the ownership patterns. She is skilled in coaching, lecturing, research, curriculum Development, and management. She has conducted research in the Mutual Fund industry (Portfolio, Risk Management and Financial analysis). She has published papers in international journals in the area of bank management, efficiency analysis, trade finance and money laundering. Her areas of interest are Micro and Macroeconomics, International Economics, Quantitative methods, Econometrics and International Trade Finance.

them in few minutes. However, we all know such anomalies do exist, and it can be explained by behavioral theories only. Moreover, the entire philosophy of values investing as followed by many fund managers is based on the Behavioral finance theories. Hence identifying and understanding the behavioral biases will help investors from falling into common psychological traps.

According to Hirschey and Nofsinger (2008), Behavioral Finance is defined as "A study of cognitive errors and emotions in financial decisions". The decision-making biases are divided into two categories – cognitive and emotional biases. Cognitive biases are the result of an error in the way we process our information whereas emotional biases are the result of social influence and life experiences. In this article we will discuss five very important biases which affect our investment decision making.

- Over confidence bias: This is an illogical faith that an investor has in his ability to predict the market. Many of the investors believe that they are gifted and have special intuition and reasoning skills that help them to predict the market. They believe they have 'special investment acumen' which helps them to pick the next winning stock at a very early stage. Due to overconfidence bias many of them buy risky penny stocks and trade too often. Both actions are detrimental as they end up picking wrong stocks because they tend to ignore negative information. This is considered to be one of the most difficult biases to avoid. From an investor's point of view, differentiating between confidence and overconfidence is almost impossible. This is what makes investing difficult, as well as interesting.

- Framing bias means that investors are more responsive to the context in which information is presented as opposed to the content of the information. Investors tend to invest if the details related to the investment are framed optimistically. When an investment is framed in

- the context of a loss, it will innate loss aversion behavior, this response which is true and real is ignored by the traditional finance theories. We can avoid framing bias by not resorting to investment shortcuts and by focusing on wealth creation. It takes conscious training on behalf of the investors to overcome framing bias

- Loss aversion bias: Humans tend to feel the pain of a loss twice as intensely as the joy of an equivalent gain. Hence, they take action to avoid loss. Investors suffering from loss aversion biases may choose to hold onto their investment hoping it will recover. The biggest drawback of loss aversion is the missed opportunities. The major attributing factor for a loss aversion behavior is a strong fear-based emotional bias that is founded on prices, rather than investment fundamentals.

- Anchoring bias: Even the most sophisticated finance wizards are affected by anchoring bias. It is a mental flaw which impacts decision making as the investor focus on the first or initial information about the price of the stock and view all the subsequent information in the light of that anchor. Because of this bias, investors tend to look at the past performance and assume that it will continue to remain so in the future and delay selling their investment. The most effective way to overcome the anchoring bias is to stop using mental shortcuts. The key fact is that investors need to be vigilant about the possibility that they may be irrationally anchored which might impact their finances adversely.

- Herd mentality bias: Human beings are social animals hence as a survival technique they attune to the actions of the larger group. In a stock market when

- a large number of people act in the same manner at the same time, it manifests in the form of volatility and also creates bubbles. Not all herding is bad, herding can be efficient or inefficient. In the case of efficient herding, all investors arrive at the same decision. However, that same decision is also the right decision from a mathematical valuation point of view. Inefficient herding is when a lot of investors agree on a decision. However, in hindsight, the decision appears to be incorrect or even absurd. This type of herding is responsible for financial disasters. Herd mentality bias is really the worst amongst all types of behavioral biases. Investors need to manage this bias, or else it could have a serious negative impact on their net worth.

In addition to the aforementioned biases, there is many other behavioral biases that can be detrimental to the investment decision making like recency bias, conservatism bias, mental accounting bias etc.

Cautionary note for investors: Investment is a very complex activity hence investors need to use the principles of behavioral theories to make sound investment decisions. What we need to understand is unlike the assumptions propounded by the traditional financial theories that, investing being a completely rational process that can be undertaken with mathematical precision is actually incorrect. The vast majority of investment decisions are made emotionally based on impulsiveness and ignorance. Investors need to be vigilant about their own thinking and analyse their thought processes as human mind tends to omit a lot of vital information leading to wrong financial decisions.

Many of the aforementioned biases has fueled many asset bubbles in the past. It is important to realise that even knowledge of behavioral economics will not lead to perfect investment solutions. However, learning these biases will help investors to minimise the biases and irrationality. Even the most sophisticated investors don't have control over the subconscious decisions made in their minds.

Lastly, investors shouldn't waste time try to find the optimal portfolio because they have neither the time nor the resources to find the best assets to invest in. Instead, investors should focus on a strategy called "satisficing" which tries to achieve the best decisions within the constraints and boundaries imposed on them. We can safely conclude that the study of finance and financial markets is incomplete without the study of behavioral economics. Educating investors on behavioral theories and biases will enable them to be better prepared for investment in the financial markets.

RECAP ON KEY ECONOMIC INDICATORS

Bahrain's Real GDP
6.9% YoY

Bahrain's Oil Sector
-2.2% YoY

Bahrain's Non-Oil Sector
9.0% YoY

Bahrain's Inflation
+0.3% MoM
+4.0% YoY

S&P GCC Composite Index ended 2.3% higher in October 2022

World Economic Growth
Growth of 3.2% in 2022
Growth of 2.7% in 2023

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