

GCC Inflation – Turning Around

Inflation is the rate at which general prices are rising - the higher the prices, the lower the purchasing power of the consumer. Inflation may discourage investments and saving in the economy because of fear of lower return in the future. According to the monetarist theory the excessive expansion of money supply will inherit inflation. When an economy is experiencing growth in the business cycle prices should increase because of the increased domestic demand. But since the “economy” is broad, many other factors can influence inflation such as the strength of the currency relative to others, import size and prices of foods and commodities.

In GCC, inflation was never a big economic issue, not until the new millennium when oil prices started to take stage for pick up. In 2002, oil prices ended at US\$31.21 which was considered high during that time. This trend continued and in 2003, oil prices averaged at US\$32.50. Inflation in the GCC for 2003 was measured at 0.6% which increased to 1.7% in 2004 .

GCC Inflation Rates

(%)	2004	2005	2006	2007	2008F
Bahrain	2.3	2.6	2.2	3.3	4.5
Kuwait	1.3	4.1	3.1	5.5	11.3
Oman	-0.2	1.9	3.4	5.8	11.2
Qatar	6.8	8.8	11.8	13.8	15.0
Saudi Arabia	0.4	0.6	2.3	4.1	11.5
UAE	5	6.2	9.3	11.1	12.9
GCC	1.7	2.6	4.3	6.3	11.5

Source: IMF, Global Research

During 2004-2007, Qatar and the UAE were recording high inflation rates among their GCC peers. Factors that contributed to their increased inflation were their demand for labor and increasing prices of rents and building materials. Both countries witnessed significant growth in the construction sector, and also witnessed a steep increase in money supply. In 2006, Qatar M1 grew 53.2% while it M2 grew 43.3%. As for the UAE, in 2006 M1 grew 29.2% and M2 33.8%. Increasing money supply leads the economy with a pool of liquidity that in return will increase the velocity of money and increase inflation .

The other GCC countries including Kuwait, Saudi Arabia, Oman, and Bahrain have enjoyed low inflation rates. GCC inflation rate was 2.6% in 2005 while oil prices hovered around US\$61.06. In 2006 inflation rate in Bahrain was at 2.2%, Kuwait 3.1%, Oman 3.4% and Saudi Arabia 2.3%. But by 2007, inflation started its noticeable jump to new levels. In the beginning of 2007 oil prices were trading at US\$60.77, a 94.7% increase from 2002. This means more revenues to the GCC oil exporting countries resulted in increased liquidity and therefore inflationary pressure.

Increase in oil prices played a big role in increasing prices of other goods and commodities. Governments in the GCC started to pile up huge current accounts surpluses due to the prices of oil that were hitting an oil time high during 2007 and 2008.

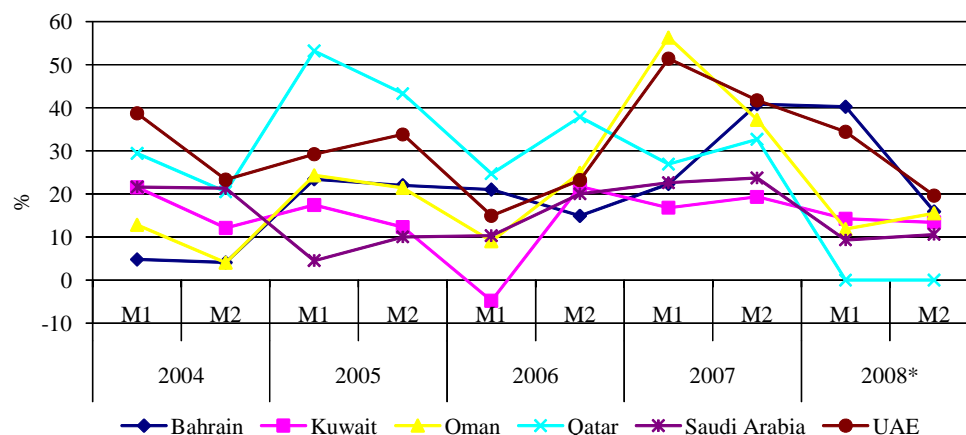
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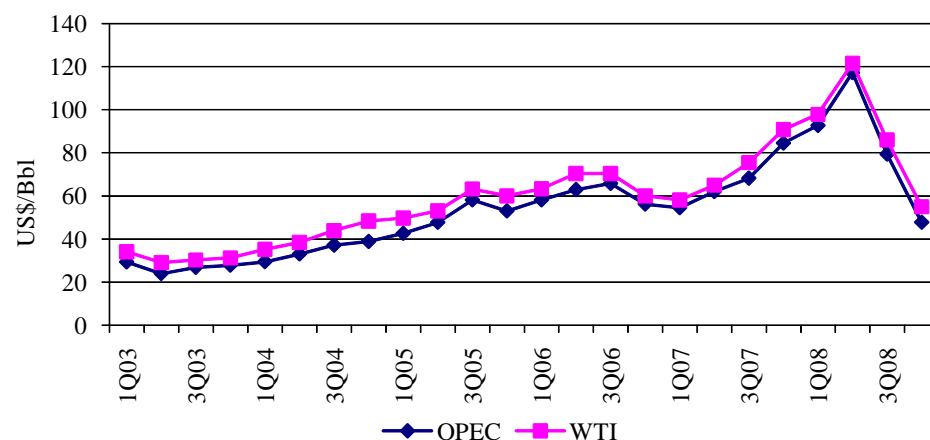
Money Supply Growth, M1-M2



Source: Respective Country Central Banks & Global Research

New projects were unveiled, infrastructure plans were announced, and oil refineries were in the process of being developed. Therefore, the rise in oil prices has increased the liquidity in the economy due to the government spending which lead to creating a huge pool of liquidity available in the economy. This increased liquidity has created a booming domestic demand, increasing money supply, increasing commodity prices and hiking housing rates.

Oil Prices



Source: EIA & OPEC

A rise in US dollar value causes cheaper imports because the purchasing power of the GCC pegged currencies appreciates against other world currencies. Therefore, gulf nations can import more products at lower prices. If the dollar value decreases then imports become more expensive because most GCC imports are not from the U.S which means that GCC pegged currencies will have a lower purchasing power due to lower dollar .

Since 2001, the dollar started to lose value against major currencies. From 2001 to 2008, the dollar lost an average of 40% against a basket of currency, a reason why Kuwait de-pegged its currency and adopted the basket of currency in 2007 .

In addition to the currency depreciation, GCC countries increased wages for their citizens. Increase in wages acts as a fuel for inflation, also as a way to relieve increased prices for the consumer. Kuwait increased salaries by KD150, Qatar increased civil service wages by 30%, Saudi Arabia increased wages 15% over the next three years, and UAE increased prices between 20%-70%. This rise in disposable income fuelled inflation because people have more money to spend.

The best strategy for wage increases is being used by Saudi Arabia, by matching wage increases with inflation rates. This method will not result in the rise in prices because employees will have their salaries increase by annual increments. And noting that inflation will cool down in Saudi Arabia, the consumer will have an improved purchasing power in the next three years .

The growth environment has led to inflationary pressures directing the GCC countries to have an average of 11.5% forecasted inflation rate for 2008. All-time high inflation numbers are estimated to be recorded this year. Kuwait's inflation is expected to reach 11.3%, Oman 11.2%, Qatar 15%, Saudi Arabia 11.5%, UAE 12.9%, and Bahrain 4.5%. All the oil exporting countries were hit hard by inflation .

According to IMF report, the headline inflation in the oil exporters in the MCD countries which are comprised mainly by the GCC countries was 15.9% based on the latest available data from these economies. Food prices were a major contributor to inflation, and the IMF estimated food inflation to stand at 20.4% while fuel inflation was 18.2%. As expected, core inflation which does not include food & fuel inflation was lower than headline inflation by 4.9%. Hence, food price increase was a major source of inflation in the GCC countries .

High inflation in the GCC was never an issue in the GCC, and consumers never worried of inflation. However, the inflation concept became a major worrying shadow. Many a times the GCC countries were criticized by experts for continuing to peg their currencies with the US\$. GCC countries were advised to fix their monetary policies by either de-pegging their currency or revaluing it .

Time is the healer of all wounds, and with the current financial crisis, the investors are hedging towards the dollar which is gaining strength among major currencies which means GCC countries will have stronger currencies.

World Economies on the way to deflation

In the last few weeks, commodity prices have started dwindling on the back of slowing demand as the global economies await a recession that will be the worst in decades. Falling prices across international economies may lead to excessive deflation that would exacerbate the global economic condition even further .

None of the developed-nations experienced deflation in recent times, except when Japan's Consumer Price Index (CPI) decreased by 1.6% in 2002. The last time the US experienced deflation was in 1954. However, the US witnessed a massive deflation during the Great Depression, when consumer prices fell by 26% between 1929 and 1933. The fall in prices was a major factor in worsening the impact of the depression .

A major cause of a deflation can be a sudden drop in demand which is currently taking place. For example, recently the retail sales in US recorded a drop of 2.8%, the largest in US history. Another major cause of deflation is the process of de-leveraging that the private and public sector are experiencing at these times. The de-leveraging process slows down the velocity of money which is the frequency of money spent during a specific time period .

Excess deflation has two major consequences: debt deflation and extremely high real costs of borrowing. First, high debt deflation represents an environment of falling assets financed by debt, like the current situation in the mortgage market in the US. Secondly, deflation drives real costs of borrowing extremely high in order to induce investors to lend cash that could earn value with out bearing credit risk of any kind. For example, short-term real interest rate reached 13% in 1931 .

CRB Reuters Commodity Index Performance in 2008 (Points)

Source: Bloomberg

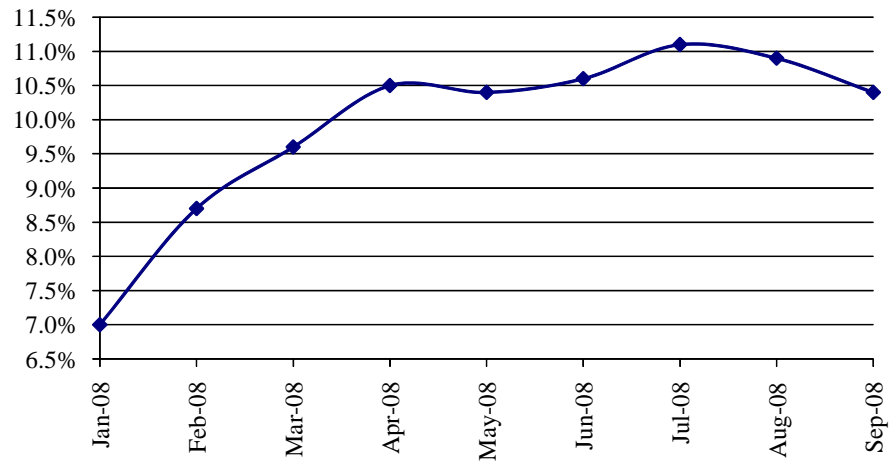
Signs of deflation start to show up, as the inflation rates slow down and commodities prices are on a free fall. Commodities ranging from energy, agricultural, livestock's, and metals including gold are declining at a rapid pace. CRB Reuters, a broad commodity index, reached its all high in July recording 481 points. Afterwards, the index declined by more than 30% as of mid-November reaching the 335.6 points. Oil prices fell by more than 50% since it hit all time high in July of 2008. Another sign of deflation is that worldwide inflation rates start to slow down. For example, UK inflation rate for October decelerated to reach 4.5% from 5.2% a month earlier. This 0.7% drop is the biggest drop in at least 11 years. Besides, the US experienced a substantial drop in inflation levels in October, when inflation rates dropped by 1% which is the largest drop in 61 years to reach 3.7%. Additionally, core inflation (headline inflation excluding fuel & food inflation) declined by 0.1%, the most in more than 20 years .

Even though worldwide current fiscal and monetary policies provide more liquidity to ease the credit market, the combination of falling commodity prices and de-leveraging process that the financial market is witnessing should outweigh the expansion in both monetary and fiscal policies. Hence, deflation will be the dominant macro theme for 2009, in addition to the global recession that is starting these days .

GCC Inflation in 2009

Factors that have been fuelling inflation in the GCC countries are turning around, most importantly imported inflation which is basically an increase in price levels caused by importing essential products from inflationary economies. Imported inflation will stabilize if not decreased for two reasons. First, the US dollar is gaining momentum against major world currencies. The US dollar index (USDIX) which tracks the dollar value relative to other major currencies went up by 87.33 points in mid-November, a gain of more than 11.7% from beginning of September this year.

Thus, most of the GCC countries that had their currencies pegged to the dollar should witness a decrease in non-US imports prices. Second, the decline in commodities will factor into the prices of finished goods. Depending on the degree of deflation from the exporting countries, finished goods like machinery, textiles, and others should experience a fall in prices . Apart from fall in prices of goods & commodities, the rents of dwelling units are also likely to soften in many countries on the back of increased supply.

Inflation in Saudi Arabia

Source: SAMA

Therefore all these factors putting together should slow down the price level increases in the GCC countries. In fact, slight decrease in inflation rates had been reordered in some of the GCC countries. For example, in Saudi Arabia, the largest GCC economy, consumer price level declined from 11%-plus in July 08 to 10.4% in September 08. Therefore, in 2009 inflationary pressures in GCC countries are likely to cool off, might be to single digit levels in many countries .

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