



straight talk

from the Chief Economist
on developing news and issues of enduring interest
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inflation set to continue in the region: no pains, no gains

Rising inflation has become a critical issue for consumers, businesses and policy makers in the whole GCC region. Recent reports put consumer price (CPI) inflation at around 14 per cent in Qatar, and 11 per cent in the UAE in 2007. We expect the numbers to remain high this year as well (12% in Qatar, 9% in the UAE). This compares with average inflation rates below 5% until the year 2003.

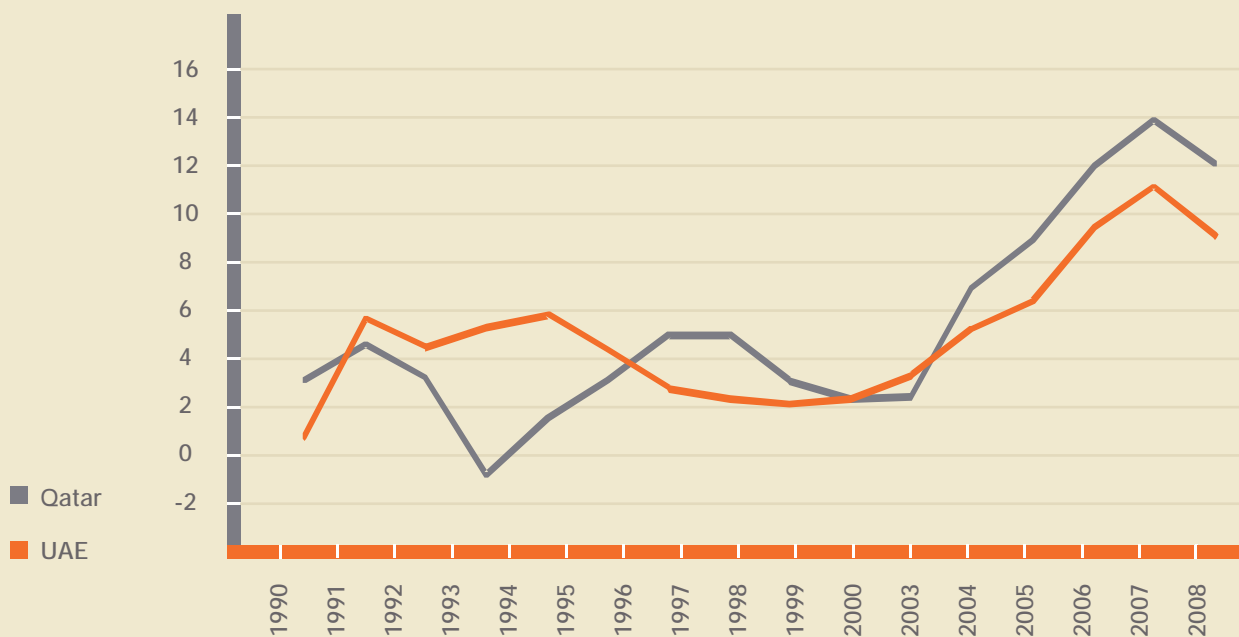


chart 1: consumer price inflation

The broad macro picture on inflation is validated by the first ever survey of business optimism in Qatar, conducted by Dun & Bradstreet in partnership with **al khaliji** and the Qatar Finance Center. According to the survey of 250 business owners and senior executives from a broad spectrum of Qatar businesses, **63 percent of non-Oil and Gas (O&G)** company respondents and **90 percent of Oil and Gas** respondents expect their prices to increase in the next quarter.. **meaning further inflation.**

Over **38 percent** of the non-O&G and **40 percent** of O&G companies surveyed say that inflation and rising input costs are among their major concerns going forward. This is an indication of “**pricing power**” that businesses have (i.e., the ability to raise prices in the market), in order to maintain or increase profits.

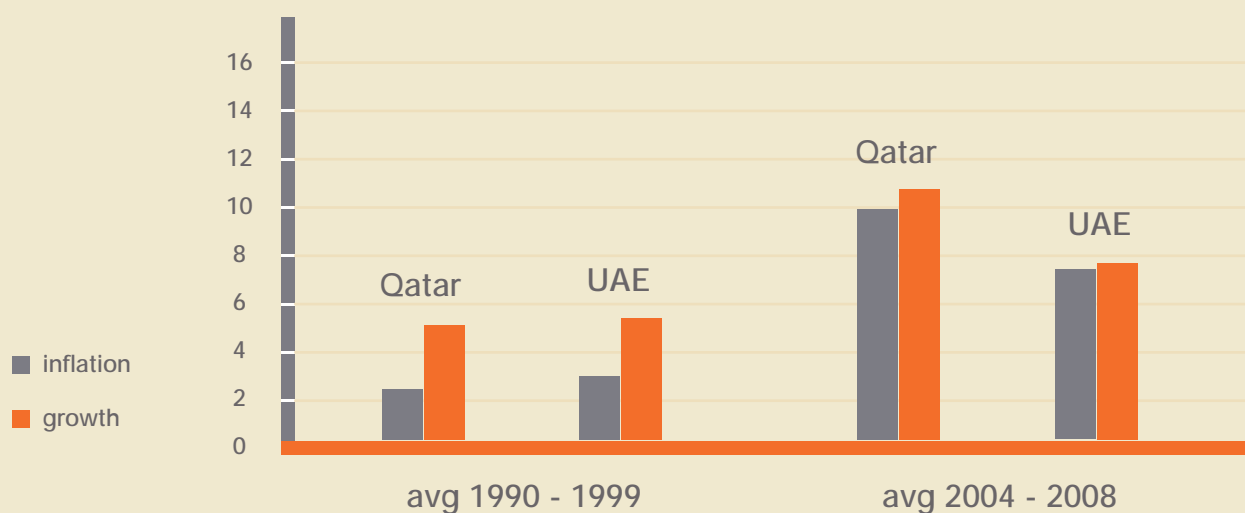
The survey shows that despite continued inflation and cost concerns, businesses expect rising profit levels in the months ahead. In the survey, **74 percent** of non-O&G respondents and **100 percent** of O&G respondents expect their profits to increase in the next quarter.

Among the different business segments, ‘**Agriculture and manufacturing**’ and ‘**Building, construction and real estate**’ companies exhibit the greatest optimism in terms of price increases, i.e., 71% and 68%, respectively, expect their prices to rise. Our view is that this is a reflection of imported inflation in the former sector and capacity bottlenecks in the latter sector.

On the other hand, the two sectors least optimistic about increasing prices are ‘Finance, insurance & business services’ and ‘Trade, transport and hotels’. Their optimism levels with respect to rising prices: 45% and 40%, respectively, of the two sectors are not expecting any increase in their profits next quarter. This relative lack of pricing power reflects, in our view, the fact that these two sectors are highly competitive (many participants and a relative lack of product differentiation?).

what makes GCC inflation tick?

Inflation is a natural product of the liquidity-driven economic boom that the GCC is currently enjoying. The two charts below illustrate this story all too well for Qatar and the UAE: high growth in recent years (2004-2008) has been accompanied by high inflation in both the countries when put in a historical context, while low growth in the past was accompanied by low inflation.



there is no free lunch

Inflation is the “price” that any country has to pay for growth (“growing pains”). If people want to avoid the pain of inflation, they have to pay a price in the form of lower growth (“no pains, no gain”). This involves cutting government spending and liquidity (i.e., demand), the underlying reasons behind the hydrocarbon liquidity-driven boom in the GCC.

but, there are some mitigating circumstances

GCC governments can cut spending on a targeted basis to mitigate some of the pain. Instead of cutting day-to-day expenditure (e.g., wages and consumption) that have a direct impact on people's welfare, they can stretch out or delay some investment projects farther into the future.

In the GCC, inflation has also been exacerbated by two other factors: a falling dollar driving up imported inflation, and "temporary" supply-scarcity driving up food, commodity, property and rental prices.

The "temporary" inflation usually goes away by itself, **given enough time**, as scarcity is relieved by additional supply (the time it takes to build housing units, increase production, and import additional supplies, etc). Governments can take some short-term actions to help mitigate this temporary inflation (e.g., by acting as "supplier of last resort", rationing demand, or imposing temporary price controls; temporarily lowering the price of fuel will be a big help).

external aggravations: imported inflation and the falling dollar

Imported inflation has two sources, one that the GCC governments cannot control and the other that they can. Globally, food and other commodity prices have surged since 2007 due to rapid growth in emerging markets demand, diversion of global corn output into ethanol production, and droughts in key agricultural producing countries like Australia. The IMF's commodity price index has risen by a cumulative 10 percent in 2008 after having increased by about 30 percent between December 2006 and December 2007.

GCC countries cannot control this commodity price inflation at the source. However, they can mitigate its impact on local prices by revaluing their inflation-eroded currencies. Studies show that the falling dollar has caused the QAR and the AED, for example, to become undervalued by as much as 20-30%. This means that a 20-30 percent revaluation would make people whole from past inflation. Certainly, this would not eliminate future inflation, but it will help mitigate the impact of inflation by allowing consumers, in essence, to "catch-up" with the loss of purchasing power from accumulated imported inflation.

The bottom-line question thus boils down to the following: Which is the lesser evil for GCC countries: restoring people's purchasing power and making a new start, or taking a hit on the value of dollar-denominated foreign assets held by GCC investors?

next month:

One more reason to get off the “rock”: Businesses will gain from a de-pegging, according to the first ever business optimism survey for Qatar by Dun & Bradstreet, sponsored jointly by al khaliji and the Qatar Financial Center.

Economics Team: **Zahid Khan, Ph.D.**, Chief Economist and Executive, Treasury and Debt Capital Markets

For enquiries or to add your name to the mailing list please contact: zkhan@alkhaliji.com, or visit our website at www.alkhaliji.com.

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al khaliji, P O Box 28000, Doha, Qatar , Tel: +974 494 0739.