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Construction growth spurs UAE inflation

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Inflation in the UAE is rising as more buildings are built. From a mere three per cent in 2003, the CPI inflation rate has picked up dramatically in recent years.

Inflation is currently around 12 per cent, and the construction sector has been largely blamed.

The country is witnessing massive real estate projects which have resulted in rising costs of construction materials. As a result, authorities have imposed a ceiling on cement prices.

However, due to high oil prices, the construction sector has been affected by soaring air and sea freight rates - a matter of concern since the UAE must rely on imported construction materials.

As the construction sector has a weight of just over 36 per cent in the consumer price index, the price pressure has helped to keep inflation high.

Contributing factor

One contributing factor behind the UAE's booming construction sector is the availability of cheap credit.

The bank lending rate is lower than the current inflation rate, indicating that the real interest rate - the actual cost of borrowing - is negative. Not surprisingly, domestic credit growth has been strong recently.

For instance, from 2005 to 2006, the growth in domestic credit expanded by a buoyant 34 per cent, of which the construction sector was the biggest recipient (30 per cent) followed by business (25 per cent) and government (22 per cent).

In Dubai, wages have started rising in response to rising living costs, which were up 15.3 per cent year on year.

In a bid to contain inflation, the government announced a 15 per cent cap on rent increases in 2006, but that did not have a noticeable impact on the housing market.

Even the more recent seven per cent cap in 2007 is unlikely to improve the situation as the city suffers from a shortage of housing. In Abu Dhabi the situation is similar.

The UAE thus faces a policy dilemma. On the one hand it must continue to build more properties in order to satisfy the growing local demand; on the other hand it must squeeze credit to curb soaring inflation. Is there a way out?

The answer depends partly on the way credit is being distributed among businesses. Credit for construction of housing projects is justified as long as the supply of housing is inadequate.

However, the dominant player in the construction industry is the retail sector, which has been expanding rapidly, particularly in Dubai.

Dubai has nearly 1.3 million square metres of retail space, which is about a quarter of the total shopping area in the Gulf. More importantly, billions of dollars are in the pipeline to build new shopping malls, luxury hotels and other retail facilities.

While these retail developments are important steps toward building the tourism industry, the massive construction boom has in turn caused inflation.

A desired policy intervention would be to prioritise the UAE's growth sectors and spend money wisely. Competing demand for construction materials between real estate (mainly housing) and the retail sector often results in a shortage of raw materials, thus creating upward pressure on prices.

Experience has shown that the present inflationary pressure cannot be addressed by resorting to a ceiling or cap. Since most of the inflationary pressure exists in the construction sector, priority should be given to those construction projects (e.g. housing) that benefit residents most in need.

Data indicates that there is an acute shortage of housing, whereas existing retail space is adequate to accommodate the current demand.

Clearly, policy is not aiming to identify the source of the problem. The government needs to prioritise its growth sectors in a manner that is consistent with sustainability of overall growth.

The authorities can undertake large construction projects sequentially rather than simultaneously, so that excessive buildups do not upset domestic inflation.

Present-day inflation is a textbook case of prolonged (hard) pegging of the dirham against the dollar, which has left limited flexibility for the Central Bank. As such, a revaluation should be a central element of the UAE's anti-inflation policy.

Revaluation would help to reduce the impact of global commodity price inflation because commodities are priced in dollars, so that a revaluation lowers their domestic price in dirhams.

However, instead of making this adjustment the authorities are hoping to control inflation by placing some excess oil revenues in stabilisation funds - mainly invested abroad - which, unlike China, has helped to limit domestic liquidity growth.

Nevertheless, the money supply has increased in tandem with domestic credit. The broad (M2) money supply grew at a brisk 23 per cent between 2005 and 2006. Even after adjusting for CPI inflation, money growth has remained high in 2007.

Resilient demand

In a nutshell, inflation will remain high due to resilient domestic demand, a robust external sector and the strong growth in potential output.

The continuation of the UAE's undervalued exchange rate means a continuing trade surplus (a soaring $34.9 billion in 2006) and large foreign direct investment inflows, which means further monetary expansion.

The UAE's anti-inflationary measures to contain inflation do not appear to be working. The authorities have failed to advocate any fundamental measures that can properly address the inflation problem.

There is no single policy prescription that will change the outcome of the endemic inflationary pressure already accumulated in the economy.

What is at stake is too important to ignore. A combination of monetary policy tightening, revaluation of the dirham and slowing down the pace of retail sector construction would be appropriate to deal with inflation.

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