

## All fall down

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The expatriate workers have paid the biggest toll of inflation in terms of falling purchasing power and loss of savings.

Since its most recent peak in 2002, the dollar has depreciated in real effective terms about 20 per cent. During the same period, the nominal effective exchange rates of the GCC countries have depreciated by 12.5 per cent (on a cumulative basis).

The dollar is falling partly because the US's trade deficit has picked up in recent years, causing investors to diversify their funds away from dollar-dominated assets.

In contrast, despite their robust current account surpluses, GCC currencies are falling mainly because they are pegged to the dollar. The dollar now stands historically low against major currencies such as the euro, in which GCC trade takes place.

Among other things, a weaker domestic currency makes imports relatively expensive. This has been a particular concern for the GCC economies, which have to rely on imports of essential goods such as food and construction materials.

As a result, most GCC nations are suffering from high import inflation. Interestingly, the dollar's slide has had an asymmetric effect on inflation between the two sets of countries.

Despite the weakening dollar, the US is enjoying stable inflation mainly due to the Federal Reserve's sound monetary policy, but the prolonged exchange rate peg has allowed limited flexibility in terms of monetary policy against inflation in the GCC countries.

In 2003-05, inflation in the GCC averaged about two per cent, but increased to seven per cent in 2006-07. Of the six Gulf economies, only Qatar and the UAE have experienced double digit inflation, primarily due to higher food and rental prices.

Due to the absence of an independent monetary policy, the GCC countries had to rely on fiscal policies to remedy the inflation problem.

### Action

Efforts were made by the governments to contain inflation. For instance, the creation of stabilisation funds to help limit domestic liquidity growth and administrative measures such as caps on rent rises or

a ceiling on cement prices were undertaken with this aim in mind.

Whereas basic economics says that price/rent controls cause shortages, the case is uniquely different in the GCC (particularly the UAE), where more and more new investments are emerging mostly in the real estate and construction sectors.

Clearly, high demand pressure is mostly to blame for the persistent inflationary pressure in the UAE. Besides the robust oil sector, the overall expansion of the UAE's non-oil sector is very high due to strong domestic and foreign investment.

Tourism is booming and capital spending in real estate and infrastructure is soaring. Furthermore, the rapid growth of the population (currently around five per cent) also underpins robust domestic demand.

The real GDP is currently growing over eight per cent and is expected to be resilient in the upcoming years.

Higher domestic demand has been complemented by higher money growth. The UAE's money supply has been growing much faster than its GDP.

Between 2003 and 2006 the growth in broad money has averaged over 20 per cent and is expected to grow strongly. The growth rate of banks loans is also very high.

In other words, the UAE's financial conditions are still very loose and conducive to inflation. This is one of the well-known disadvantages of exchange rate pegging in which central banks often pursue overly expansionary policies that are not discovered until too late, when sustained inflationary pressure has begun.

Fortunately, administratively controlled prices of oil, coupled with the low cost of expatriate workers, has helped to limit the pass-down of higher fuel costs to domestic prices in the GCC.

The average pass-down of rising international prices to domestic prices is only 12 per cent in the GCC compared to that in the oil-importing countries. Nevertheless, the benefits of the low cost of products seem to have been overshadowed by the costs of exchange rate pegging.

The soaring current account surpluses of the GCC countries have raised expectations regarding currency appreciation. However, with pegged exchange rate regimes, the expectations of appreciation have translated through higher domestic inflation. Consequently, inflation expectations have been implanted in the public's mind.

Numerous newspaper reports indicate public perception concerning worsening inflation in the GCC. Thus far, expatriates have paid the biggest toll of inflation in terms of falling purchasing power and loss of savings.

Therefore, even if the inflation problem may not seem a big threat to GCC economic stability, the worsening inflation expectations will.

Against the backdrop of soaring inflation, the market is speculating that the central banks will respond

accordingly by revaluating domestic currencies. Kuwait has responded justifiably by appreciating its dinar by nearly 2.5 per cent last summer.

Of course, more revaluation is needed to reduce the pressure of import inflation, but the move by Kuwait's central bank is surely welcoming.

On the contrary, in a recent meeting of GCC finance ministers in Qatar, the UAE decided not to drop its dollar peg.

Interestingly, the likelihood of a change in the dollar peg has increased in the forward markets as the dollar-dirham three-month forward rate has moved from factoring a 1.4 per cent move to 1.9 per cent move by next February.

## **Different response**

The different responses of Kuwait and the UAE regarding revaluation remind us of the response of France and the UK after the September 1992 exchange rate crisis.

As noted by Columbia University economist Frederic Mishkin, immediately after the crisis, France continued to peg its currency to the German mark and thus was unable to use monetary policy to respond to domestic conditions.

The UK, on the other hand, dropped out of the exchange rate mechanism and adopted inflation targeting.

A decade later, France found that its economic growth remained slow and unemployment increased, whereas the UK enjoyed much better economic performance and a lower unemployment rate. Yet the UK's inflation performance was not much worse than France's.

It remains to be seen how Kuwait and the UAE will adjust their exchange rates against the dollar and how this will affect future inflation rates.

Although it may be an exaggeration to relate the GCC's present situation to the 1992 exchange rate crisis, an important lesson to be learnt is that the cost to economic growth from a pegged exchange rate regime with its absence of independent monetary policy can be high.

The dollar is likely to slide further. In fact, the dollar's decline will help to reduce the US current account deficit.

For GCC countries a falling dollar means that inflation pressure will remain and the continuation of exchange rate pegging means continuing trade surpluses and more foreign direct investment inflows, which means further monetary expansion in the GCC countries.

The basic economics here is straightforward. Inflation is caused by money growth and in the long run inflation and money growth move together. Nevertheless, a hardline stance against revaluation has always been "business as usual" in the GCC countries.

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