

## Inflation in a very uncertain state

<http://archive.gulfnews.com/articles/08/05/25/10216044.html>

05/26/2008 11:17 AM | By **Dr Syed A. Basher**, Special to Financial Review

**Once it's in the system, inflation has to be well enough contained, since it has the occasional tendency to get out of control and thereupon have a serious impact upon the real economy**

In any country, inflation generates severe costs. One of the most important costs of inflation is the uncertainty it creates about future inflation itself. And uncertainty about future inflation makes it difficult to plan well for the future.

In particular, inflation uncertainty reduces the efficiency of the price system, thereby creating distortions in allocating resources. Some groups gain (e.g. homeowners), others lose (e.g. owners of savings accounts).

Prudent behaviour becomes in fact reckless, and reckless behaviour in fact prudent. In the end, and in the most general sense, government's capacity to govern is reduced, and pressure for strong action grows.

Why should higher inflation lead to greater inflation uncertainty? Why does inflation uncertainty matter? These questions are of key importance to the science of economics and the practice of policy alike.

We can try to answer these questions within the context of the GCC economies, where inflation rates have been persistently higher and projected to remain strong in 2008.

By inflation uncertainty we simply mean the lack of complete knowledge about how future price levels will be determined. For example, at the end of 2006 a person may have predicted that 2007 inflation had a 90 per cent probability of being between three per cent and five per cent.

At the end of 2007, if the same individual predicts with 90 per cent probability that 2008 inflation be between four per cent and seven per cent, we say that his uncertainty about 2008 inflation is greater than it was for 2007 inflation.

In practice, inflation uncertainty is more sophisticatedly measured. The basic idea is that higher inflation leads to greater variability of inflation, greater inflation variability implies greater uncertainty about future inflation, and greater inflation uncertainty has a detrimental effect on economic activity.

Why might inflation uncertainty itself increase with inflation? The answer to this question is difficult. Numerous economic studies have documented a significant positive relationship between inflation rates

and the variability of inflation.

Economic theories argue that when inflation is high, disinflationary policies may trigger higher inflation variability because the timing and short-run impact of policy on inflation are uncertain.

For example, when inflation is high at the same time as the economy is in a slump, it is not clear whether a central bank will adopt disinflationary policy by increasing interest rates or give priority to moderating the depth of economic downturns.

Thus, uncertainty about the timing of policy increases inflation variability.

Although the GCC region is experiencing high inflation alongside strong economic growth, powerful disinflationary policies could not be adopted so far owing to ineffective monetary policy and rapid fiscal expansions.

Moreover, despite various price control measures being taken to reduce inflation as it is measured (see chart), the underlying inflationary pressure could not be dampened, amidst the current policy vacuum. As a result, uncertainty about future inflation has risen.

So what are the consequences of inflation uncertainty? There are several channels through which greater inflation uncertainty may affect our daily activities.

Contracts involving future payments such as wages or rents are seriously affected when the real value of future payments is uncertain.

For example, when landlords are uncertain about the real value of future rents, rent payments are likely to soar as a result of the changing perceptions (see chart).

Likewise, employees tend to demand higher wages when they do not know what the money they earn today will buy tomorrow. Overall, inflation uncertainty has the capacity to affect major economic variables, including interest rates, profits and prices.

Greater inflation uncertainty confuses consumers and businesses between relative prices (for instance, the price of rice relative to taxi fares) and the general price level (an overall basket of prices).

The basic idea is that it is difficult to understand whether there has been a change in the relative price or the overall price level.

Such confusion can lead business to produce, at least temporarily, the wrong level of output. If many firms make these mistakes at the same time, then the result is an unnecessary fluctuation in the aggregate output of an economy.

Uncertainty about interest rates and other economic variables can ultimately reduce overall economic activity.

When businesses are uncertain about future interest rates, they may prefer to delay the hiring, production and investment decision until more information is known. This is particularly relevant for investments that are irreversible or are specific to a particular model or product.

For example, a car manufacturer may postpone a decision on opening a new plant to see if a rise in demand is temporary or appears likely to last.

Increased inflation variability may even lead businesses to spend more resources improving their forecast of inflation. In particular, some businesses may try to hedge against unexpected inflation using specialised financial instruments, such as derivatives.

As a result, resources are diverted away from more productive business purposes towards forecasting and hedging activities.

The notion that higher inflation increases uncertainty about future inflation is supported by many analyses. These analyses unequivocally argue that a monetary authority could reduce inflation uncertainty by reducing inflation itself.

The GCC economies have a tendency to view inflation as exogenous (essentially an external force, often confining their attention solely to imported inflation) or maintain the idea that the recent inflation phenomenon is transient, just like previous episodes.

Yet, today's persistent and local nature of inflation has surely proved this notion wrong. It may be too late (or costly) before the region realises the importance of prudent fiscal-monetary orientation in conquering inflation.

As such, inflation uncertainty can only be reduced by actually lowering the level of inflation.

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# INFLATION

## % 2008 PROJECTED



SOURCE: IMF

# GCC OFFICIAL RENT CAPS

**SEP 2007**

**LOCATION**

**RENT CAP**

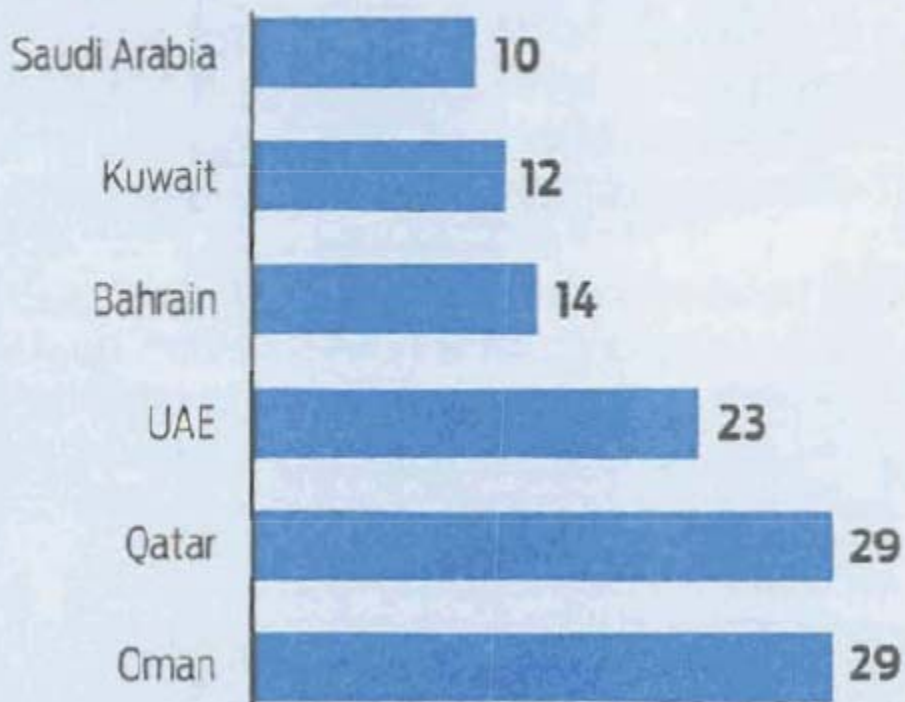
Sharjah	*0%
Abu Dhabi	7%
Dubai	7%
Qatar	10%
Oman	15%

\* No increase allowed for 3 years.

SOURCE: GULFTALENT.COM

# AVERAGE RENT INCREASE

**% RISE, AUG 2006 - AUG 2007**



SOURCE: GULF TALENT.COM