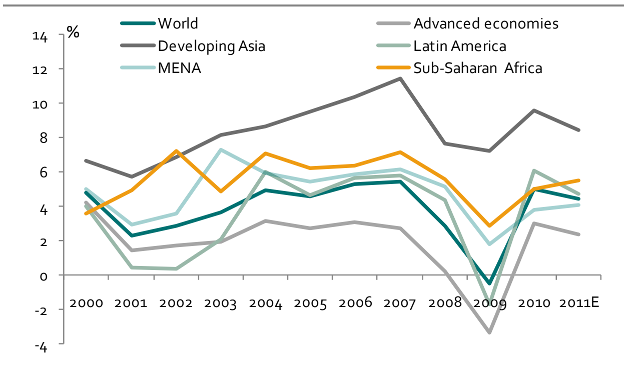
# INFLATION: THE GLOBE AND SAUDI ARABIA

## 1. Inflation rears its ugly head

Inflation rather than growth is emerging as the main headache for policymakers

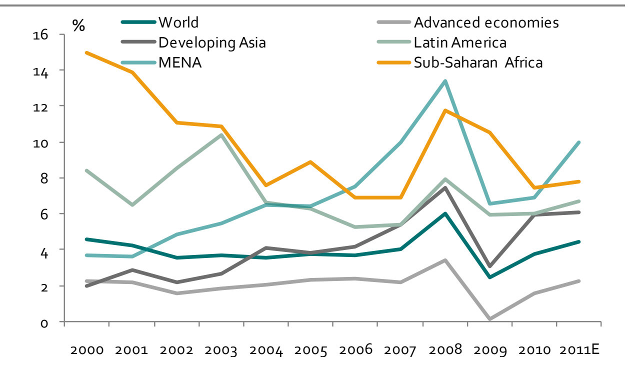
The global economy has been on the path of a strong recovery despite hiccups in the Eurozone and a fragile growth story in the US. Growth has been mainly led by emerging economies of Asia and Latin America, although those of the likes of Germany have also been expanding rapidly. The flipside of such growth has of course been an emergence of inflationary pressures across the world from end-2010. Asia has been the most to suffer with policymakers forced to refocus attention to curtail prices rather than support and stimulate growth. So, from Vietnam to India fiscal stimulus measures have been withdrawn and central bankers have tightened rates. It is ironic that inflation has managed to rear its ugly head, barely a year post the recovery from the global downturn.

Figure 1. Real GDP growth across key regions




Source: IMF

Figure 2. Inflation across key regions




Source: IMF

According to the IMF, average annual inflation in India was 13.2% in 2010

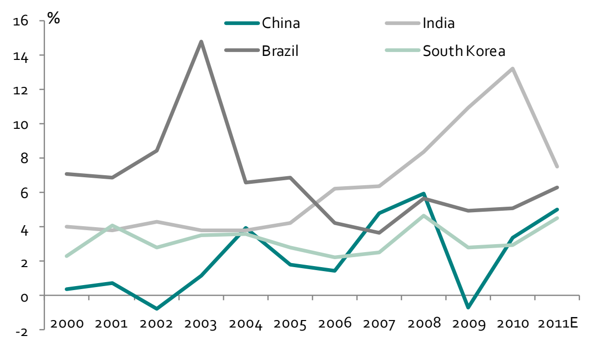
Inflation in Asia has been the most notable, no doubt driven by strong growth over 2010-11. In India, for example, the International Monetary Fund (IMF) puts average annual inflation for 2010 at 13.2% and despite strong monetary tightening the figure is not expected to move below the central bank's target of 5% in 2011 as well. China is also not far behind with inflation accelerating to 3.3% in 2010 from -0.7% in the previous year. Despite steps by the People's Bank of China (PBOC) to check credit growth, inflation concerns are likely to persist in the world's second largest economy with the IMF forecasting a rise in consumer prices to the tune of 5.0%. Latest figures put May inflation at 5.5% for China and 9.1% for India. Among other fast growing economies, prices have been inching higher in South Korea, Vietnam, Brazil and Turkey. Vietnam is probably the worst affected with the headline inflation figure for June 2011 touching 20.8%.

Inflation, however, has not been restricted to emerging economies alone. In the UK, inflation has been higher than the Bank of England's (BOE) target rate of 2% for

The ECB hiked rates by 25 bps in April, bringing to a close a long period of low interest rates in the region

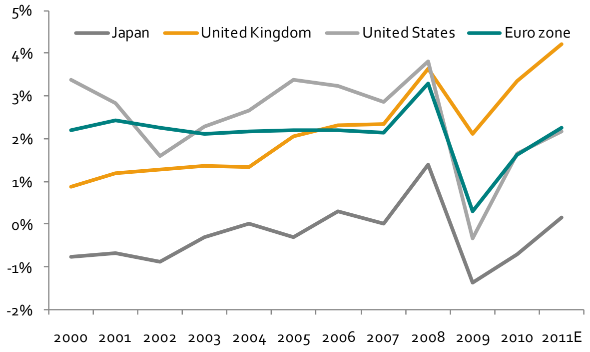
quite some time now. And in the Eurozone, despite a debt crisis in periphery economies, the European Central Bank (ECB) raised rates by 25 basis points (bps) in April. This brought to a close a reign of low interest rates in Europe. It was also the first time that the ECB has preceded the US Federal Reserve (Fed) in raising rates. Japan however continues to suffer from deflation, with growth of annual consumer prices still in negative territory. This has prompted growth concerns, especially for an economy battered by natural disasters and suffering from a loss of export-competitiveness due to an appreciating Yen.

Figure 3. Inflation in Asia and Latin America




Source: IMF

Figure 4. Inflation in advanced economies




Source: IMF

The US credit downgrade (Standard & Poor's downgraded the US's 'AAA' credit rating by one level to 'AA+' on August 6, 2011) along with the deteriorating fiscal health in Eurozone has severely affected the financial sentiments and the risk appetite globally. This has renewed fears of a double-dip recession in the US and Western Europe. US growth for the first quarter of this year has already been revised down from an annualized 1.9% to 0.4% while second quarter growth came in at 1.3%, much lower than economists' expectations of 1.8%. In the Eurozone, Germany and France, both reported zero growth in the second quarter, while emerging markets too are witnessing moderation in growth. India's economic growth slowed down to 7.7% in April-June quarter 2011 (down from 8.8% a year ago). Consequently, the global economy is more likely to grow at a slower pace than anticipated earlier. In light of the slower global economic activity and hence demand, the commodity prices are likely to come down; crude oil price (WTI) has already come down from the average of USD 98.1 per barrel in first half of 2011 to USD 84.4 per barrel currently. This is likely to ease pricing pressure both in the developed markets as well as in the developing markets in the near term.

## 2. Strong growth a key reason behind price pressures

India and China grew by 10.4% and 10.3% respectively in 2010

The emergence of inflation in Asia is not surprising given that economies in the region have recorded some of the fastest growth. China and India are the two best examples. Both economies were resilient during the crisis and aided by strong fiscal and monetary policy support they recorded stellar growth in 2010. According to the IMF, while China grew by 10.3% last year, India's GDP growth was marginally higher at 10.4%. For 2010, the IMF puts GDP growth for 'Developing Asia' at 9.5% while for 'Emerging and Developing Economies' the corresponding figure is 7.3%. This year, despite intervention by policymakers to quell demand and thereby dent the rise in consumer prices, economic growth in Asia is not expected to simmer down significantly. Growth fundamentals in these economies are still strong and both China and India are expected to lead global economic growth in the coming years. While Chinese growth is expected to hover in the range of 9.2 – 9.6% over 2011–16, in India, the corresponding figure has been put at 7.8 – 8.2%. Consequently, inflation concerns will persist over the years with figures for price rises remaining much higher than those in advanced economies.

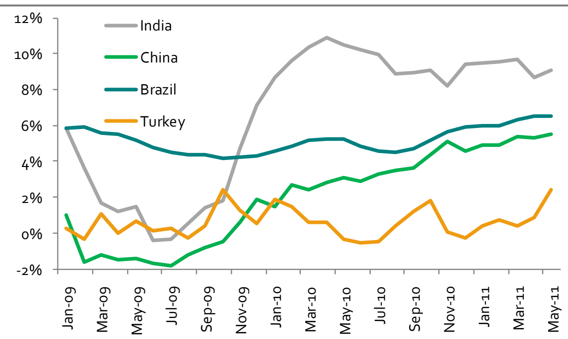
In China, inflation moved up to 5.5% in May 2011 while in India it was 9.1%

Inflation in India, as measured by the Wholesale Price Index (WPI), has been above the Reserve Bank of India's (RBI) target rate since December 2009. Although at that time, a low-base effect was making its presence felt, over time these effects have given way to predominantly demand-side pressures (as actual GDP growth shot past potential GDP growth). After touching a peak of 10.9% in April 2010, inflation has hovered between 10.5 – 9.1% in the one year period up to May 2011. A similar pattern can also be observed in China, although the scale of price rise is lower than India. Consumer inflation has been increasing steadily in the country since January 2010 and touched 5.5% in May 2011. The phenomenon of rising prices seems most problematic for Vietnam with inflation in double digits since November 2010 and moving up to 20.8% in June this year.

The growth of the middle class has been a key factor driving inflation in emerging economies

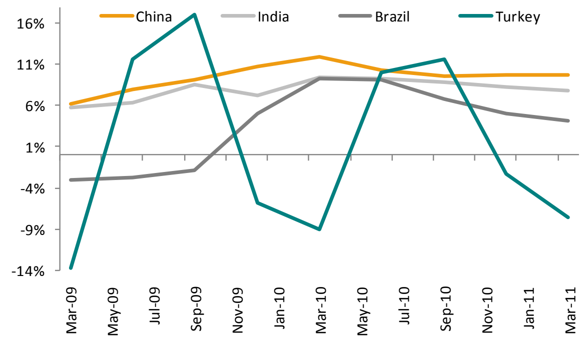
In these economies, while economic growth has brought subsequent rises in demand for goods and services, it has also meant a move up the income chain for a number of people. As the size of the middle class expands, demand for energy-intensive products, consumer durables, and food expenditure has gone up. This has had the greatest impact on price elastic items like food and energy. Hence, continued growth in emerging economies has been one of the key factors behind the rise in global commodity prices. Much of this price rise is reflected back in the consumer price indices of thee countries with a first-round impact on the food and energy component followed by second-round impact on manufactured goods. Consequently, core inflation for these economies has gone up.

Figure 5. Inflation in emerging economies



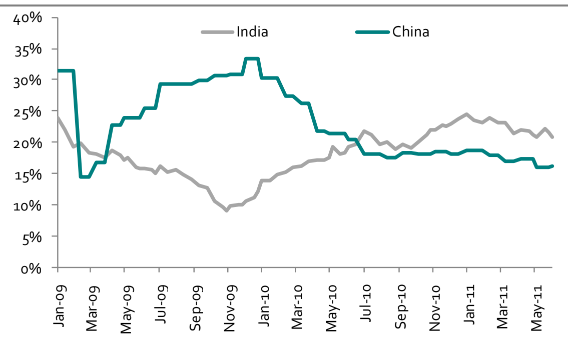

Source: Bloomberg

Figure 6. Growth in these economies



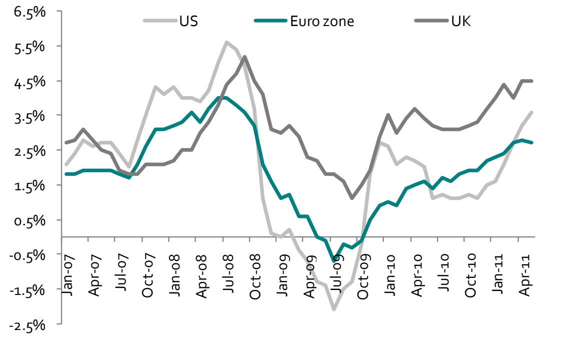

Source: Bloomberg

Figure 7. Broad money growth




Source: Bloomberg

Figure 8. Inflation in the West also moving up




Source: Bloomberg

In China, much of the rise in prices has been attributed to a real estate bubble

The wealth effect is always a key component of rise in consumer demand and thereby eventually of inflation. 2010 in particular witnessed a strong rally in asset markets in emerging economies. While reviving equity markets has meant higher wealth for consumers in these economies, the effect has been further buttressed by strong growth in real estate prices. In fact, a real estate bubble is one of the prime concerns for policymakers in China, with both the PBOC and the government striving to rein in credit growth towards the sector. With asset composition of people in emerging markets tilting more towards investments with a higher risk and reward component, any rally in these assets has meant a strong wealth effect thereby forcing consumption demand even higher. The result of this has been fairly evident in Asia. It is however interesting to note here that any possible bursting of asset bubbles could dampen the inflation spiral, although the toll on the overall economy would be much higher.

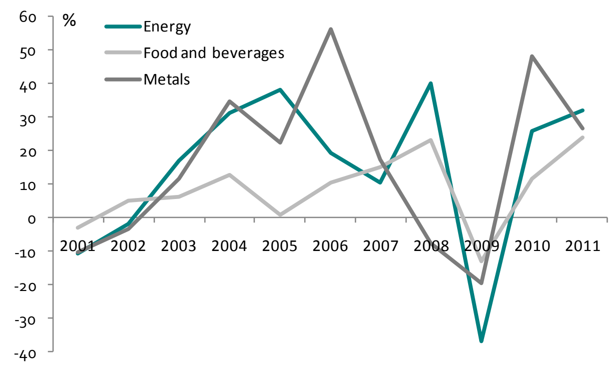
## 3. Supply side pressures have grown steadily

Not all-upward pressure on inflation has been from the demand side. Global commodity prices have been on a strong upward trajectory since the fall of 2008-

According to the IMF, commodity prices rose by 26.1% in 2010 and this year it is expected to rise by 29.3%

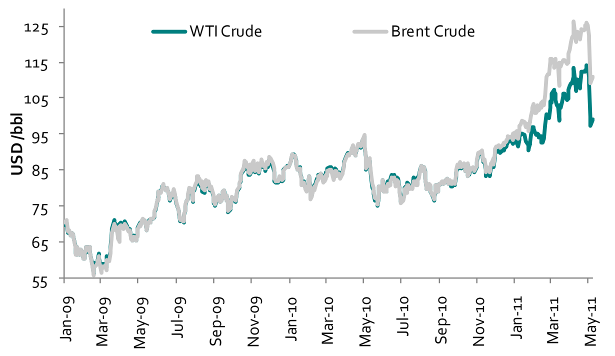
09. Rising food prices have not only forced consumer prices higher, it has also pushed millions of people into poverty. At the same time, energy prices have grown strongly, buoyed by higher global demand and speculative inflows into commodities due to concerns pertaining to equities and a weak dollar. The IMF's overall commodity index grew by 26.1% last year (after falling 30.1% in 2009). This year a 29.3% growth is expected – more than enough to keep up the pressure on consumer prices across the world.

Figure 9. Growth in IMF's commodity indices




Source: IMF

Figure 10. Crude prices have been moving upward




Source: Bloomberg

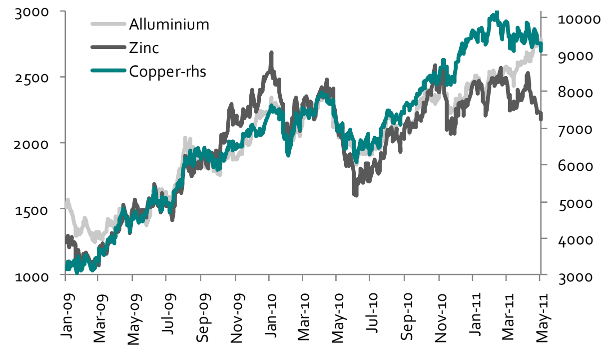
On an annual basis, energy prices are likely to rise by more than 30% in 2011

The rebound in energy prices in 2010 is apparent given the sharp falls witnessed in the previous year due to the global economic slowdown. The IMF's index for energy prices, which takes crude, natural gas and coal prices into account, rose by 26.0% in 2010. This year, the Fund expects the rise to be even higher at 31.9%. This is not surprising given that global demand growth continues to be high even as a weak dollar and uncertainty in equity markets have prompted money into commodities once again. The latter pattern is very much on the lines of mid-2008 when speculative activity was as much to blame for a spike in crude prices as was demand and supply fundamentals. This year however one more factor has added to growth in energy prices – political instability in the Middle East and North Africa region. While political upheavals in Egypt and Tunisia have been important, the crisis in Libya has ensured that a vital member of the Organization of Petroleum Exporting Countries (OPEC) has not been able to offer supplies into the market. Consequently, crude prices have risen steadily this year with growth in Brent prices of over 16% in 2011.

The FAO food index recorded a growth of 37.1% in May 2011, up from28.1% in January

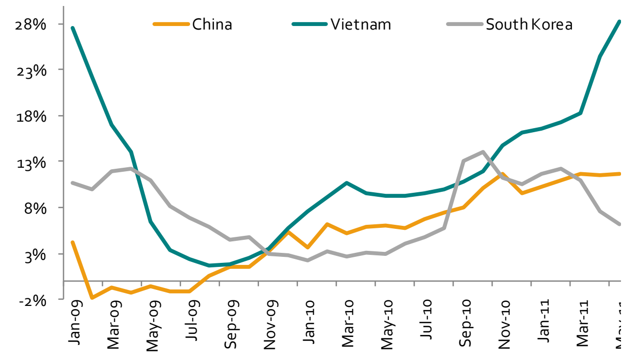
The rise in food prices has been the most worrisome for developing and emerging economies. With a large number of people in these economies living below the poverty line, any rise in prices implies a setback in poverty alleviation and further strain on public finances due to large amount of food subsidies. The Food and Agriculture Organization (FAO) has been constantly cautioning about this rise in food prices. Apart from single digit growth in May and June of 2010, YoY growth in FAO's Food Price Index has been in double digits since November 2009. While a low-base effect is apparent in the first few months since that time, the surge in the index this year has meant that the rise in food prices has been more of a secular trend. This year, the index's growth has gone up from 28.1% in January to an astounding 37.1% in May.

Figure 11. **Prices of key base metals**




*Source: Bloomberg*

Figure 12. **Food inflation in Asia**

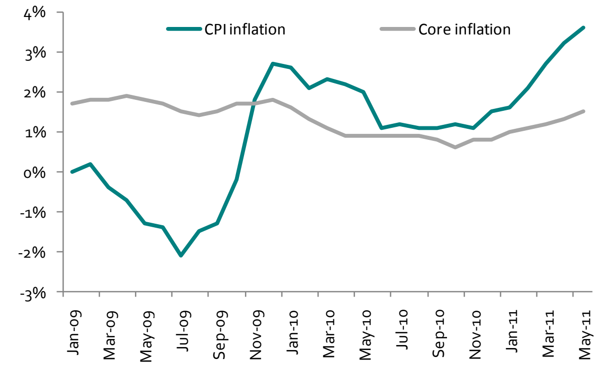



*Source: Bloomberg*

In the US, food and energy prices have not yet percolated down to core inflation

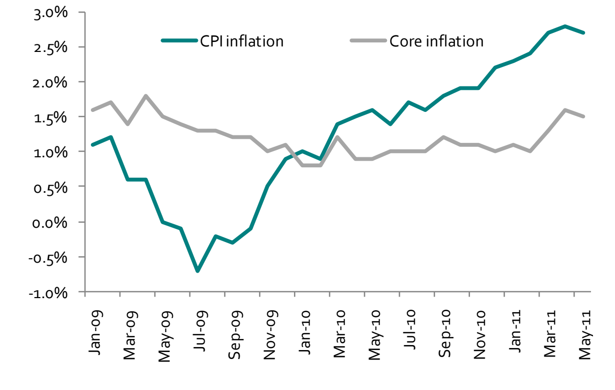
The impact of food and energy prices on consumer prices across the world is most apparent in the growth in the food-related component of respective indices, and the divergence between headline inflation and core inflation. In China, for example, a food inflation of 11.7% in May was one of the main drivers of the headline figure of 5.5%. The same was the case with India. On the other hand, the divergence between headline and core inflation is most prominent in countries where supply-side pressures have not yet percolated to core inflation. The US is such an example where headline consumer prices have been rising on account of higher gasoline prices. Consequently, while headline inflation rose to 3.8% in May this year, core inflation was at 1.5%. However, this will still be a source of worry for the Fed, which has been encouraged to keep monetary policy loose due to low inflation concerns. Any pass-through of volatile food and energy prices to the other components of the consumer price index (CPI) would imply higher core inflation figures, thereby forcing the Fed to embark on a tightening phase in a high unemployment environment.

Figure 13. Inflation in the US




Source: Bloomberg

Figure 14. Inflation in the Eurozone



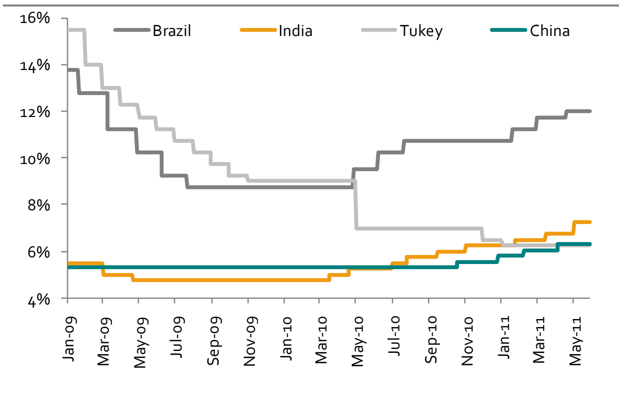

Source: Bloomberg

## 4. How inflation is complicating policy

Asian central banks have been proactive in trying to curb inflation

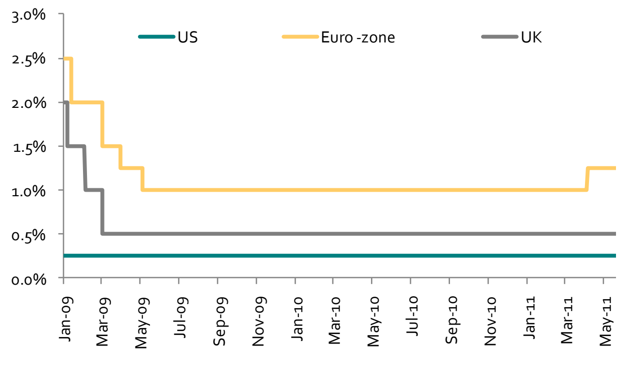
Asian central banks have been at the forefront of the fight against inflation – hiking interest rates and raising reserve requirements. Arguably, the most aggressive has been India's RBI. Since March 2010, it has raised repo rates by a cumulative 275 bps to the current 7.5%. Reserve requirements have also been raised with the first hike worth 75 bps coming in January 2010. In China, the PBOC first moved on the policy rate front in February 2010. It hiked rates by 25 bps to 6.06%, following it up with another 25 bps hike in April 2011. It has also tried to stem credit growth from the supply side by hiking requirements.

Figure 15. Policy rates – emerging markets




Source: Bloomberg

Figure 16. Policy rates –advanced economies




Source: Bloomberg

The Fed has been accused of exporting inflation by keeping monetary policy loose

A great concern among emerging market policymakers has been the inflow of short-term capital into their countries from advanced economies, primarily the US. Most of these inflows are directed at debt instruments, geared to exploit interest rate differentials between the US and these economies. Being short-term in nature, these inflows tend to be destabilizing especially given a mismatch with the nature of the current account deficit that a country might have. These inflows have been accused of leading to asset bubbles, thereby stoking inflation. Yet another impact of these short-term inflows has been the rise in the value of the currency of the recipient nation, thereby making their exports uncompetitive. Of all emerging markets, Brazil has been the most scathing in its criticism of the US. It has gone as far as accusing the Fed of Dollar manipulation (to keep it low) and exporting inflation through the latter's quantitative easing policies.

In Turkey, the CBRT has slashed rates to discourage short term foreign inflows

These short-term inflows have complicated monetary policy action for recipient nations. Raising rates to curtain inflation runs the risk of attracting even greater funds, thereby stoking further currency appreciation. In fact, the Central Bank of the Republic of Turkey (CBRT) had slashed rates in January this year in order to prevent inflows and thereby dent any further appreciation in the Turkish Lira. It opted to fight inflation by lowering reserve requirements instead. However, it remains to be seen whether this unorthodox method will be successful in countering the twin problems of rising prices and a strong Lira. While Lira appreciation seems to have been stalled, latest figures reveal that inflation has shot up sharply to 7.2% in May this year from 4.3% in April.

In the UK, high inflation threatens to derail fiscal consolidation, especially in a specter of weak economic growth

In Europe, inflation poses a strange set of problems. The UK has been struggling with high inflation for quite some time now. Since, December 2009, the rate has been higher than the BOE's target (2%). Latest figures put (CPI) inflation for May 2011 at 4.5%. This has made the BOE's task harder in trying to keep rates down to stimulate growth, especially in a specter of sharp fiscal tightening. In the Eurozone, the ECB's task has been further complicated by the sovereign debt crisis. Especially when the cost of borrowing for periphery nations like Greece, Ireland and Portugal are high, the ECB has been forced to raise rates by 25 bps – the first time since July 2008. The Eurozone also faces asymmetrical economic performance. While growth in Germany has been stellar (2010: 3.6%, 1Q11:1.5%), laggards like Spain continue to suffer with unemployment in the latter at a staggering 21.3% in the first quarter of this year.

## 5. Inflation edging up in Saudi Arabia

Headline inflation in Saudi Arabia is expected to rise to 6.0% in 2011 from 5.3% this year

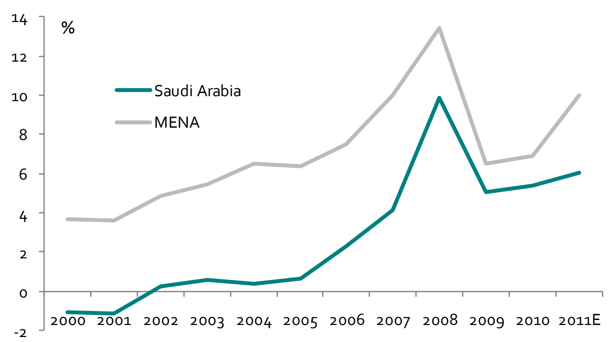
A resurgent economy and high global food prices have ensured that Saudi Arabia is no mute spectator to the inflation saga developing across much of Asia, Latin America, and even developed economies. Strong GDP growth in the Kingdom no doubt has meant a rise in demand-side pressures and this is bound to get more intense this year as the pace of economic activity intensifies. The IMF expects GDP growth to accelerate sharply to 7.5% this year from 3.8% in 2010. Consequently, the IMF expects price pressures to be higher with headline inflation rising to 6.0% in

2011 from 5.3% this year. The figure however is likely to be lower than most of the country's peers in the MENA region. Overall MENA inflation was 6.9% in 2010 and is likely to shoot up to a little under 10.0% next year.

Inflation has been on a relatively higher trajectory in Saudi Arabia since 2007 compared to 6 years prior to that

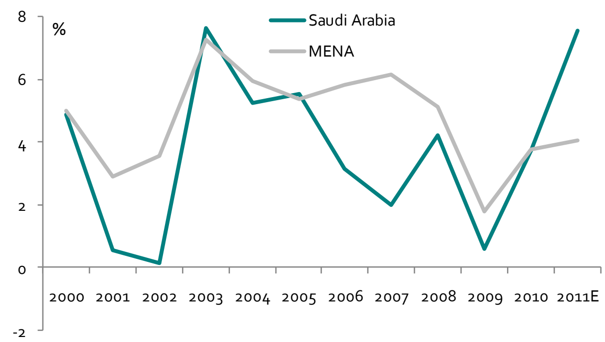
Interestingly, despite inflation being lower than peers, Saudi Arabia has been on a higher inflation trajectory for quite some time now. Traditionally seen as an economy with very low price pressures, there has been a structural change since 2007 when inflation touched 4.1% and then accelerated sharply to 9.9% the next year. This has been a result of both strong economic growth and rising global prices of agricultural commodities. Meanwhile, a lack of independent monetary policy due to the Riyal's peg with the US Dollar has also meant that SAMA has had a limited set of tools to fight inflation, especially given increasing asymmetry in business cycles between Saudi Arabia and the US.

Figure 17. Inflation in Saudi Arabia and MENA



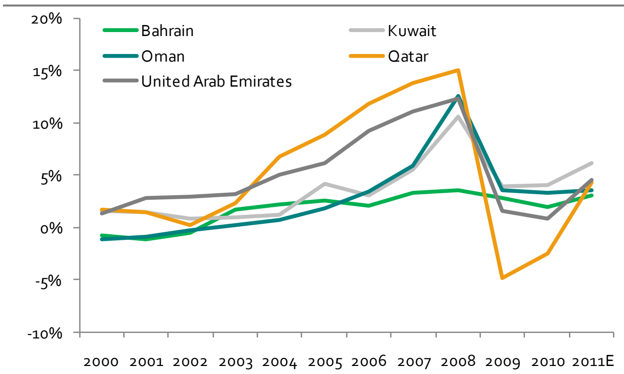

Source: IMF

Figure 18. GDP growth in Saudi Arabia and MENA



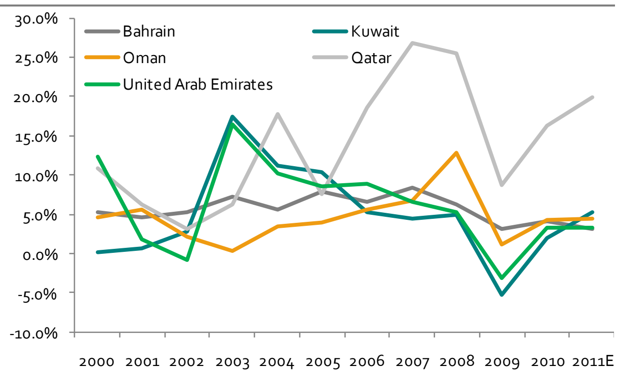

Source: IMF

Figure 19. Inflation in other GCC countries




Source: IMF

Figure 20. GDP growth in other GCC countries




Source: IMF

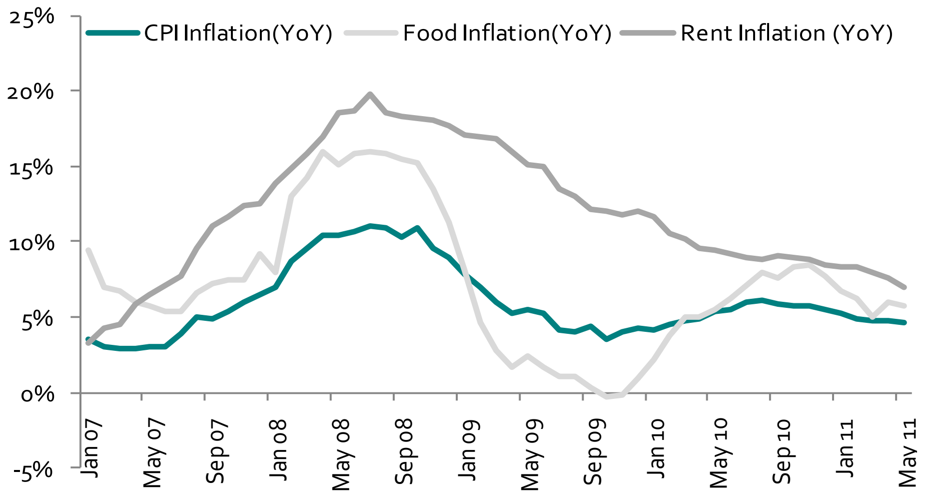
The evolving global macroeconomic environment since the US credit rating downgrade and extended sovereign debt woes in Eurozone is not likely to leave Saudi economy unscathed. On account of subdued demand, the oil prices are likely to fall; it already lost around USD 14 a barrel since now and the average during the first half of 2011. This is likely to negatively affect the flow of hydrocarbon revenues and may curtail economic activities in the country. This along with the fall in food prices in the international markets is most likely to ease the pricing pressure in Saudi Arabia.

## 6. Recent trends in overall CPI and its components

In 2010, inflation in Saudi Arabia peaked at 6.1% in August; it has gradually come down to 4.6% in May this year

While the rise in consumer prices in the first half of 2010 was natural given a reviving economy, the latter half of the year brought forth its own set of concerns. On one hand, commodity prices across the globe were heading higher while on the other, domestic growth strengthened even further. The evidence of this lies in inflation hovering in the range of 5.4 – 6.1% over May – December 2010. However, this year inflation has fallen below the 5% mark. In fact, inflation has been going down albeit marginally – from 6.1% in August 2010 to 4.6% in May 2011. However, with global food prices on a secular growth trends and domestic GDP growth set to intensify further, inflation is expected to accelerate in the second half of 2011. Upward pressure on prices will be augmented by fiscal handouts and continued loose monetary policy in the US.

Figure 21. Inflation in Saudi Arabia and its key contributors




Source: SAMA

'Food and beverages' accounts for the highest share (26%) in Saudi Arabia's CPI

Of the various components of the Consumer Price Index (CPI) in Saudi Arabia, food and beverages, rents and utilities, and transport are the most important ones. Even among these, food stands out. Due to arid climatic conditions and hence lack of a large agriculture sector, Saudi Arabia is heavily dependent on imports for its food consumption needs. Consequently, fluctuations in global food prices have a deep impact on consumer prices in the Kingdom. For example, high food prices were a key factor prompting inflation towards its peak in 2008. Similar price pressures became evident in 2010-11 as well although this was more so in the latter part of 2010.

Rent related inflation has slowed down in the last two years

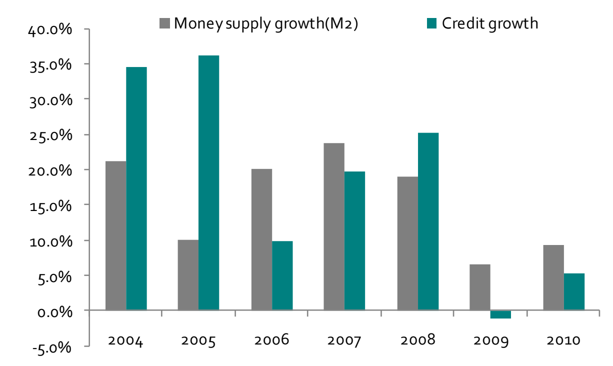
Rent related inflation has been one of the sore points in the GCC. In 2007-08, owing to a real estate boom across the region, pressure on consumer prices from rents (or housing) was the highest and Saudi Arabia was no exception to that. For example, YoY growth in the 'rents and utilities' sub-index in Saudi Arabia ranged between 13% and 19% in 2008. In fact, growth in prices in that category moved back into single digits in April 2010 for the first time since August 2007.

## 7. Higher credit growth could force inflation higher

Credit growth has picked up pace this year and is likely to put upward pressure on prices in the latter half

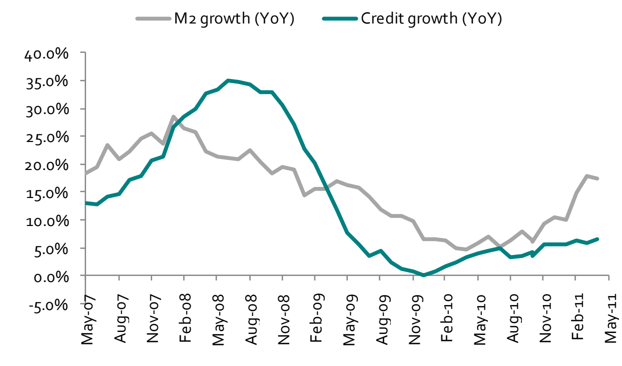
A check on prices in 2010 came from the money supply front with SAMA trying to supervise a steady growth of credit in the economy without subsequent inflationary spirals. At the same time, cautious business and consumer sentiment implied a slower-than expected credit demand growth. Total credit growth in the Kingdom was a mere 5.2% in 2010 although this was a marked improvement from the fall of 1.9% the year before. Consequently, broad money supply growth in 2010 was much lower (9.3%) than the peak years of 2007 and 2008, especially the former when the figure was 23.7%. In fact, SAMA has earned accolades for its role in preventing asset bubble of the kinds witnessed in neighboring UAE. However, this year there has been a steady rise in credit growth as economic growth has become more entrenched in the country thereby leading to improved sentiments. Overall credit growth was 6.2% YoY in the first quarter and this is expected to rise; average annual growth for 2011 is likely to be in double digits. This is likely to lead to greater price pressures in the latter part of the year.

Figure 22. Money supply and credit growth




Source: SAMA

Figure 23. YoY growth in M2 is starting to move up

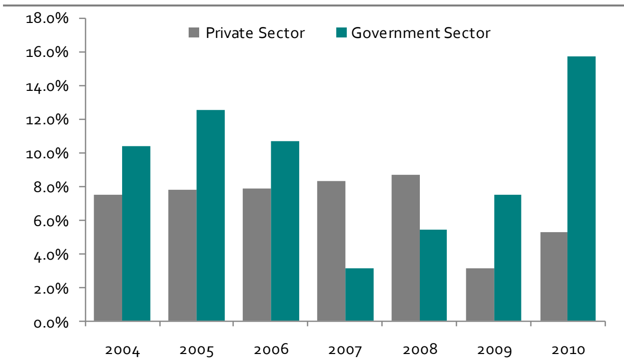



Source: SAMA

Curtailing fiscal spending is necessary to dent inflation

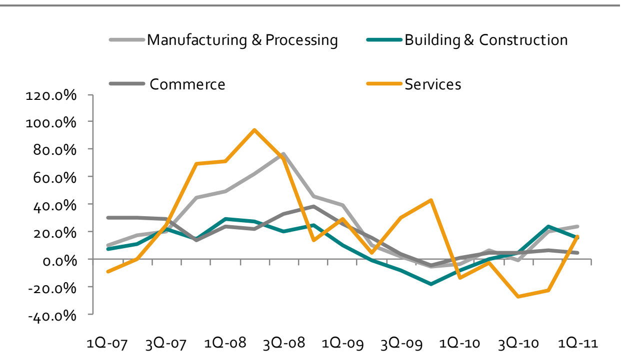
As a result of fiscal stimulus measures, credit flows to the public sector in 2010 grew at 15.7%, nearly three times the growth recorded in credit to the private sector. Curtailing government spending growth will thus be a key element in tackling inflation in 2011, given strong expected growth in both the oil and non-oil economy.

Figure 24. Growth in credit to the private and public sector




Source: SAMA

Figure 25. Growth in credit offered to key sectors




Source: SAMA

## 8. Has the dollar peg contributed to higher prices?

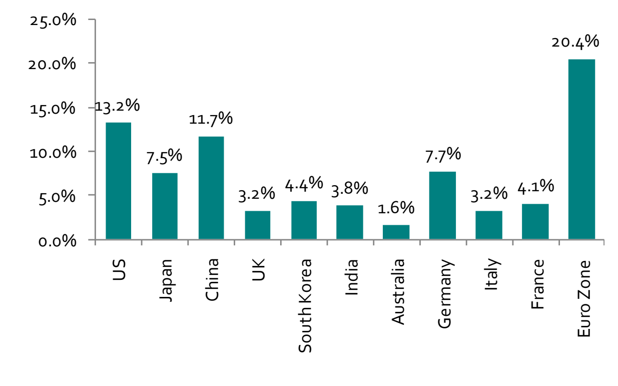
The Riyal's peg to the US dollar renders monetary policy in the Kingdom dependent on the Fed

Persistent inflation concerns in the Kingdom poses several hard questions for policy makers. The first among these is the Riyal's peg to the US dollar. The peg first came under strain in mid-2008 when there were claims that the weak dollar was contributing to imported inflation in the Kingdom. At the global level, a weak dollar was also forcing speculative activity towards commodities, which in turn led to spikes in their prices. There seems to be a rerun of the same thing this year as well with continued loose monetary policy in the US (including two rounds of quantitative easing) leading to weakness in the dollar. The impact has been higher costs, which have gradually percolated down to retail prices.

SAMA would like to avoid a repeat of 2008 when it had a slash rates at a time of high inflation

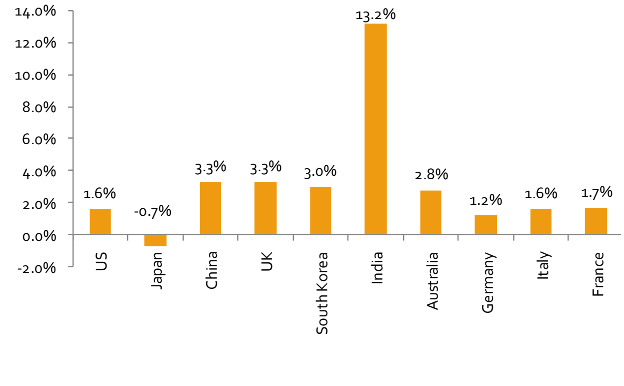
The other impact of the peg is the absence of an independent monetary policy. Consequently, SAMA has to keep in tune with the Fed. While this goes down well in the event of synchronous business cycles in both countries, strains have started to appear since 2008. At that time, the Fed was trying to stimulate growth in the US by slashing rates exactly when inflation was at its peak in Saudi Arabia due to strong domestic growth and high import prices. Consequently, just at the time in which it was required of SAMA to stem credit growth, it had to keep in tune with Fed policy. This could become a problem yet again this year with Saudi growth accelerating while the US continues to struggle with a weak recovery without any inflationary threat.

Figure 26. Import share of major trade partners




Source: SAMA

Figure 27. Inflation among trade partners




Source: Saudi Central Department of Statistics and information

## 9. Inflation passed on by trading partners

One percentage point rise in a trading partner's inflation could result in a 0.8 % rise in Saudi Arabian inflation

Yet another impact on consumer prices in Saudi Arabia can be assumed to have come from trading partners. According to the IMF, inflation in import partners is passed on to domestic retail prices and is one of chief contributors of rising prices. The study states that a percentage point increase in inflation of a trading partner could prop up consumer price growth by 0.8% in the Kingdom. In contrast, the impact of a pass-through effect of changes in the nominal exchange rate is relatively moderate. A one percentage point appreciation in the Saudi Riyal (NEER) results in mere 0.2 % decline in price levels in the Kingdom. In that context, the following table throws light on the probable impact of trading partners on inflation.

Figure 28. Riyal vs. Major Import partners currencies

| End of Period | U.S. Dollar | EURO | Sterling Pound | Japanese Yen | Swiss Franc | Chinese Yuan | Australian Dollar | Indian Rupees | Korean Won | Brazilian Real |
|---|---|---|---|---|---|---|---|---|---|---|
| 2000 | 3.75 | 3.48 | 5.59 | 0.03 | 2.29 | 1.00 | 2.07 | 0.08 | 0.00 | 1.92 |
| 2001 | 3.75 | 3.31 | 5.44 | 0.03 | 2.24 | 1.00 | 1.91 | 0.08 | 0.00 | 1.61 |
| 2002 | 3.75 | 3.93 | 6.04 | 0.03 | 2.70 | 0.45 | 2.12 | 0.08 | 0.00 | 1.05 |
| 2003 | 3.75 | 4.74 | 6.69 | 0.04 | 3.03 | 0.45 | 2.81 | 0.08 | 0.00 | 1.29 |
| 2004 | 3.75 | 5.10 | 7.20 | 0.04 | 3.30 | 0.45 | 2.91 | 0.09 | 0.00 | 1.39 |
| 2005 | 3.75 | 4.42 | 6.46 | 0.03 | 2.85 | 0.46 | 2.75 | 0.08 | 0.00 | 1.61 |
| 2006 | 3.75 | 4.94 | 7.36 | 0.03 | 3.07 | 0.48 | 2.97 | 0.09 | 0.00 | 1.75 |
| 2007 | 3.75 | 5.51 | 7.50 | 0.03 | 3.32 | 0.51 | 3.28 | 0.10 | 0.00 | 2.10 |
| 2008 | 3.75 | 5.22 | 5.47 | 0.04 | 3.53 | 0.55 | 2.60 | 0.08 | 0.00 | 1.58 |
| 2009 | 3.75 | 5.40 | 6.07 | 0.04 | 3.64 | 0.55 | 3.36 | 0.08 | 0.00 | 2.13 |
| 2010 | 3.75 | 4.98 | 5.79 | 0.05 | 3.99 | 0.57 | 3.81 | 0.08 | 0.00 | 2.26 |

Source: SAMA

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