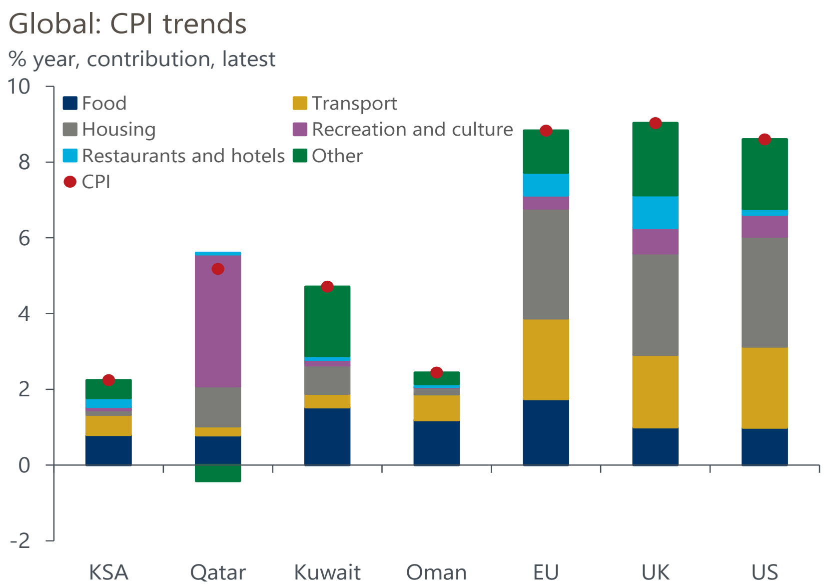
Research Briefing | MENA

Inflation heats up in GCC but is less troubling than elsewhere

- **We have raised our inflation forecast for the GCC to average 3.2% this year, up from our projection of 2.8% six months ago. However, the GCC's rate of inflation will remain below that of most advanced and emerging markets, as we expect inflation to average 7.5% globally this year.**
- **In our view, GCC inflation will follow the global trajectory and begin to ease in H2. Food and energy prices, the main drivers of inflation at present after being pushed to record levels by drawn-out pressures on supply chains, are set to fall sharply in 2023 relative to current levels. This will help bring the inflation rate down. However, strengthening domestic price pressures will keep inflation above pre-pandemic levels, as we forecast GCC inflation will average 2.5% in 2023.**
- **GCC households have been insulated from sharp price increases by food and fuel price caps, more limited stimulus in the last two years that forestalled the build-up of domestic price pressures, and the strength of US dollar-pegged currencies, which have dampened import costs.**
- **But with housing costs no longer a drag and firms increasingly passing rising costs onto the consumer (except in the UAE), inflationary headwinds will weigh on household consumption and the non-oil recovery into 2023.**
- **Regional stocks have erased all of this year's gains, reflecting concerns about inflation globally and, with much tighter policy on the way, gloomier growth and energy demand outlooks. Volatility is likely to remain elevated in the near term and tailwinds will be lacking, even barring a global recession.**

The rise in commodity prices resulting from Russia's invasion of Ukraine has been positive for GCC fiscal positions and terms of trade, but negative for regional inflation trends. The reduction in exports from the two warring countries has caused large spikes in food and oil prices since the onset of the war, reinforcing price increases in prior months. This has pushed regional consumer inflation to 3.4%, the highest rate in over a decade. But GCC inflation remains significantly lower than in other major markets, including the US, where it hit 8.6% in May. We believe GCC inflation is nearing its peak.

Chart 1: GCC inflation rates remain significantly lower than in most major markets



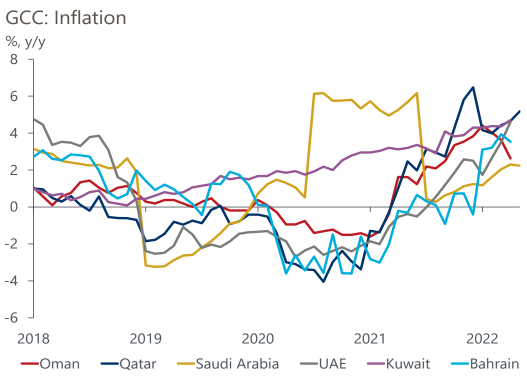
Source : Oxford Economics/Haver Analytics

Maya Senussi - Senior Economist - msenussi@oxfordeconomics.com

GCC inflation continues to rise…

GCC inflation data show prices climbed by 3.4% (on a weighted basis) in April (**Chart 2**), the last month for which we have data for all six countries. April's rate is 0.4ppts higher than in March and 1.1ppts above the average in 2021.

Chart 2: Regional inflation rates are on the rise



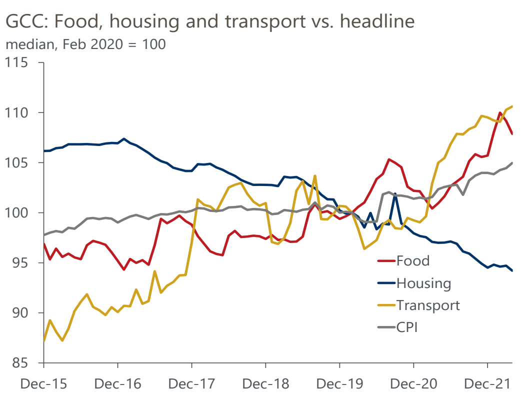
Source: Oxford Economics/Haver Analytics

** For UAE, Jan-Apr 2022 = Dubai*

There is some country divergence. Kuwait and Qatar reported the highest inflation rates in the region, at 4.7% and 5.2%, respectively. Bahrain and the UAE also continued to experience rising inflation. By contrast, inflation in Oman slowed to 2.4% in May from over 4% in Q1, as the effects of VAT introduction fell out of the annual comparison. Meanwhile, Saudi Arabia recorded a marginally lower inflation rate of 2.2% in May than 2.3% in April, albeit still double the rate at the turn of the year.

The drivers of higher inflation in the GCC are similar to those in other regions, with food and transportation seeing some of the largest price increases (**Chart 3**).

Chart 3: Inflation in the GCC this year is set to be the strongest since 2012



Source: Oxford Economics/Haver Analytics

The scale of food price increases in the GCC mirrors trends seen in many advanced economies grappling with multi-year high inflation (**Chart 1**). However, transport and particularly the housing component are contributing much less to inflation in the GCC. This reflects comparatively modest increases in fuel and utility costs in the region.

A number of factors will continue to insulate GCC households from stark price increases in contrast to global trends:

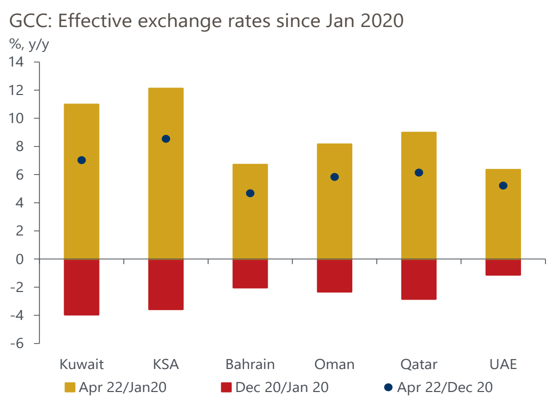
1) Price caps on fuel and food products are limiting inflation.

The price of fuel, the key driver of inflation globally, remains capped in Saudi Arabia at June 2021 levels, which were among the lowest in the world, even at the time. Meanwhile, in April, the UAE rolled out a policy framework to manage food price increases. The regulations require suppliers to clear price adjustments on staples – including milk, chicken, sugar, and rice – with the Ministry of Economy to minimise the impact on inflation. Other GCC countries have also resorted to temporary food price controls.

2) A strong US dollar, to which local currencies are pegged, will continue to dampen imported inflation.

Local currencies have surged in tandem with the US dollar, with nominal appreciation varying between 4.7% and 8.5% since end-2020 (**Chart 4**). Our view that the US dollar will remain strong, supported by the hawkish stance of the US Federal Reserve, suggests imported price inflation will remain contained.

Chart 4: Strong US dollar should dampen imported inflation



Source: Oxford Economics/Haver Analytics

3) The comparatively modest fiscal and monetary stimulus deployed by GCC governments in

response to the coronavirus pandemic and still constrained liquidity (particularly in Saudi Arabia) have forestalled the build-up of domestic price pressures.

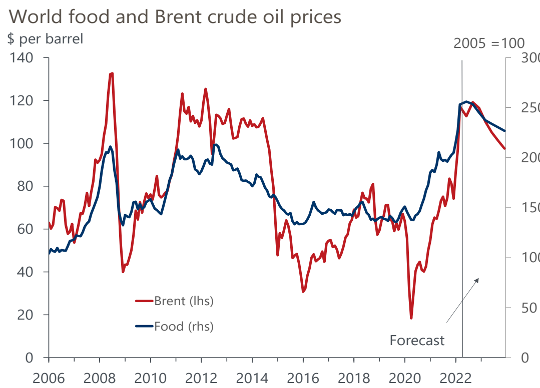
That said, the rise in prices has become more broad-based across the consumer basket. The rebound in employment, reflective of a stronger economic recovery and the pick-up in travel activity, is putting upward pressure on rents and recreation prices, which are pushing inflation higher.

...but is nearing its peak

Our baseline outlook for food and energy prices supports our view of regional (and global) inflation nearing its peak and moderating in H2.

Although global oil prices will remain elevated, averaging almost of $120pb in Q3, food prices peaked in March, when the FAO price index reached an all-time high of 159.7 (+34% y/y). Our forecasts are for both commodity groups to remain high in a historical context, but they will likely fall by 10% to 15% by this time next year (**Chart 5**).

Chart 5: Unprecedented times for global food prices



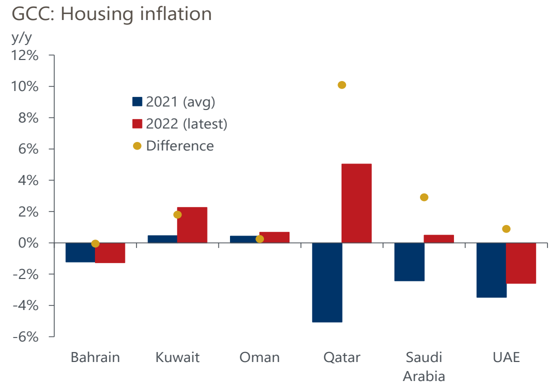
Source: Oxford Economics/Haver Analytics

Domestic drivers set to take to the fore

But as external inflationary pressures moderate, domestic factors, stemming from the strength of the regional economic recovery and its impact on demand for housing and services, will pull inflation in the opposite direction.

The housing segment, which makes up an average of 27% of the region's consumer basket, almost as much as food and transport combined, is no longer a drag on headline inflation rates, primarily due to higher rental prices. Qatar stands out for the sharpest rise in this category, in excess of 5% y/y in May, following a five-year period of falling prices (**Chart 6**).

Chart 6: Rents are again pushing housing inflation higher



Source : Oxford Economics/Haver Analytics

We look for sustained upward pressure on rentals in Qatar in the coming months amid an upswing in activity related to the football World Cup later this year. Rental prices will likewise firm in the rest of the GCC, spurred by higher demand from nationals and returning expatriate workers post-pandemic. The robust outlook will support hiring across the region and draw in foreign workers, leading to further recovery in housing demand and sustaining the rise in the rental component of CPI (**Chart 7**). That said, these increases will be weighed against the impact of higher interest rates on demand, even if regional central banks don't follow the US Fed hikes in full.

Chart 7: Housing will remain an important driver of inflation

Source: Oxford Economics/Haver Analytics

In the UAE, the series of reforms implemented over the past few years, including the long-term residence visa programme and improved laws governing private sector employment, will also attract workers, underpinning the recovery in domestic rents and pushing inflation higher.

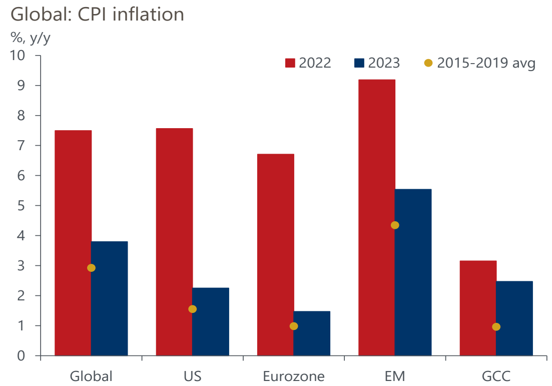
Companies in the hospitality and leisure industries are also putting their prices up in the face of higher domestic and international tourism activity. The jump in airline fares is prompting GCC residents to rethink travel plans and opt for staycations, while the surge in the number of foreign arrivals will put pressure on services inflation. The increase in prices in the recreation and culture category has been particularly sharp in Qatar, in excess of 30% y/y since March, given the events ahead of the upcoming football World Cup. However, this increase in part reflects the low base stemming from the country's strict pandemic-related lockdown in April-May 2021.

Moreover, the latest PMI surveys highlight that firms (except in the UAE) are increasingly passing rising input costs onto consumers, suggesting these pressures will endure in the near term.

Inflation will ease in 2023-2024

Overall, we see GCC inflation averaging 3.2% this year, the highest rate since 2009, though nowhere near the double-digit rates seen in 2008 and much lower than the 7.5% pace we project worldwide. Regional inflation will fall back to 2.5% in 2023 (**Chart 8**) and settle around 2% thereafter.

Chart 8: GCC inflation rate will remain above 2015-2019 level in 2023

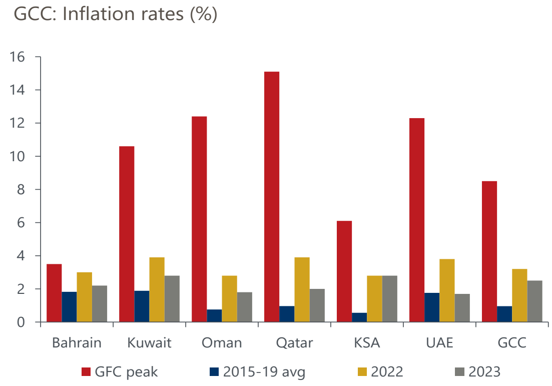


Source: Oxford Economics/Haver Analytics

With domestic drivers offsetting the decline in external price pressures, all GCC countries will experience higher inflation in 2023 than their pre-pandemic 2015-2019 average (**Chart 9**).

This will pose a headwind to consumer incomes, private consumption, and the non-oil growth outlook, which is expected to slow to 3.2% in 2023 from 4% this year. However, it will not derail the overall recovery, anchored by higher public sector spending against the backdrop of historically high oil prices.

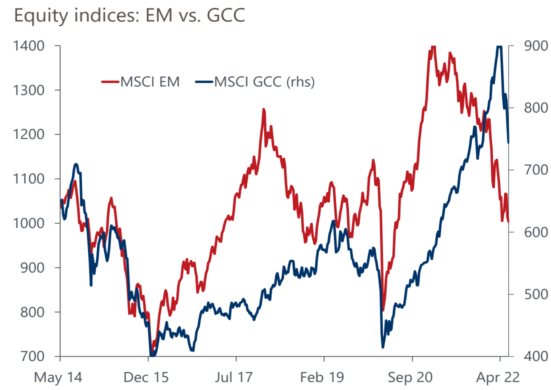
Chart 9: Inflation in GCC countries will remain above 2015-2019 level in 2023



Source: Oxford Economics/Haver Analytics

Regional stocks have erased all of this year's gains and we see no catalysts for a recovery until a scenario of global recession hanging over GCC and global markets is priced out.

Chart 10: Regional stocks have been hit by global growth and inflation worries



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