

Economics

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Qatar Macro View

Fuel Price Hikes, Inflation and Asset Bubbles

- Fuel price hikes earlier this week in Qatar have reignited concerns regarding a return of inflationary pressures in the Gulf Emirate.
- In addition to the immediate effect of fuel price hikes, we see longer term inflationary pressures building, partly as a result of the success of Qatar's 2022 World cup bid. These relate to i) a boost to sentiment and consumer confidence, and ii) the higher likelihood of timely implementation of ongoing infrastructure projects.
- We now expect annual inflation to average around 6% in 2011, compared with deflation of -2% in 2010. We believe this will come down somewhat in 2012 (to 4%) as the one-off impact of fuel/food price rises ease, and the base effect takes hold. But the longer-term inflationary pressures associated with project implementation are likely to push prices upward in 2013 (8%) and beyond.
- In our view, rising inflation will leave the Qatari authorities with three policy options. They can i) turn to fiscal tightening to control domestic demand, ii) de-peg/revalue the Riyal, iii) live with high inflation.
- We believe the most likely outcome is that Qatar will remain a high-inflation environment in the medium to long term. Combined with low nominal interest rates (anchored in US policy), we expect that real interest rates will revert to being highly negative. This will fuel demand for alternative investment and savings vehicles, prompting strong domestic inflows in local real estate and equity markets, and raising the risk of future bubbles being formed in these markets.

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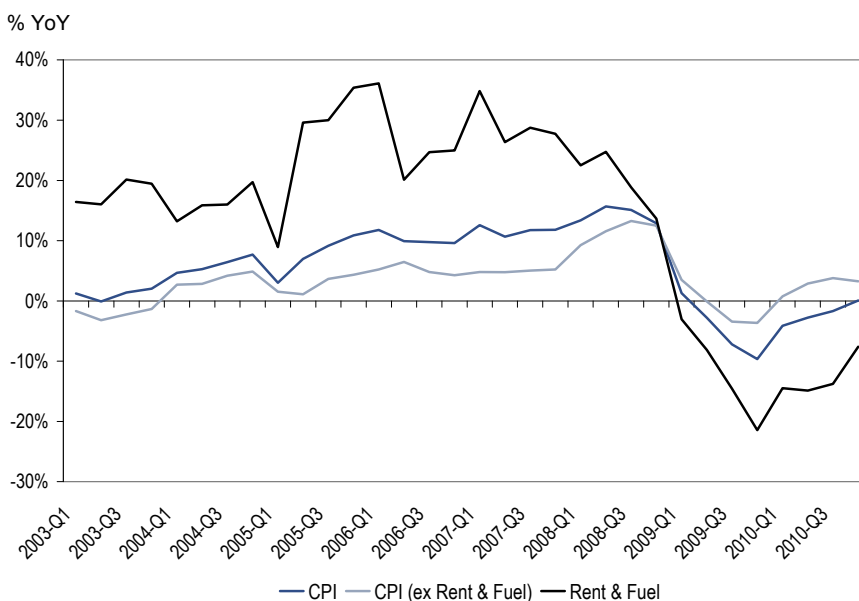
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Fuel price hikes, inflation and asset bubbles

Fuel price hikes earlier this week in Qatar have reignited concerns regarding a return of inflationary pressures in the Gulf Emirate. After peaking in 2008, inflation in Qatar fell dramatically with the onset of the global economic downturn. Indeed, deflation prevailed in Qatar throughout most of 2009 and 2010 despite robust economic growth, mainly due to a sharp fall in rents which we estimate to have troughed at 25% lower yoy at the end of 2009 (Figure 1). In recent weeks, however, we have seen a return of inflationary pressures, with yoy inflation breaking positive territory in December 2010 for the first time in almost 2 years. This appears set to pick up pace in the medium term, in our view.

Figure 1. Post economic downturn, deflation led by fall in the real estate (rental) market

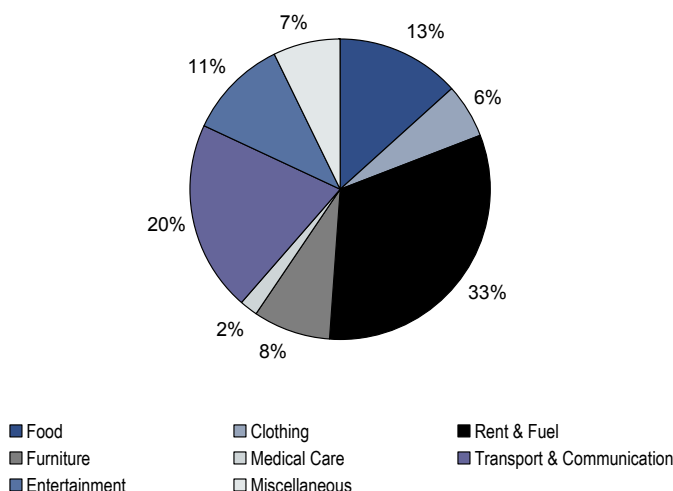


Source: Haver Analytics, Citi Investment Research and Analysis

The near-term impact of commodity and food prices

Earlier in the week, the government of Qatar issued a directive, effective within hours of its circulation, raising the retail price on petroleum products in service stations, including all ranges of petrol, diesel and kerosene, by an average 25%. We estimate that the immediate direct impact on CPI inflation will be an increase of around 1.5% yoy, given our estimate that expenditure on fuel constitutes just over 6% of the consumer basket. However, we believe that it is highly likely that the rise in fuel prices will have secondary effects on the overall price level, as fuel is a significant portion of the cost base for domestic goods and services. Reports in the local press suggest, for example, that local construction companies are seeking to re-price contracts with immediate effect in order to pass on the price hikes to clients (The Peninsula, 24 January).

Figure 2. Rent and fuel account for the largest share of consumer expenditure



Source: Haver Analytics

Transportation costs are very likely to rise sharply as a result of the fuel price hikes. Transportation on its own accounts for 20% of consumer expenditure in Qatar, and is an important component in the cost of food, spending on which accounts for a further 13% of the CPI basket. Qatar is highly dependent on food imports, with virtually no local food production, meaning food travels a long way from farm to Qatari table. Rises in local transportation costs will only add to domestic food price inflation, which has been fuelled by a sharp rise in global food prices in recent months as well as international transportation costs.

In addition to the near-term impact of the fuel price hikes, we see longer term inflationary pressures building, partly as a result of the success of Qatar's 2022 World cup bid. This will be through two main channels. First, we believe the World Cup story has resulted in a marked shift in domestic consumer confidence in recent weeks, manifesting itself most significantly in a potential bottoming out in the rental market. Second, we believe implementation of projects is likely to pick up as a result of the successful bid, upping domestic demand in the medium term, and increasing the likelihood of supply bottlenecks.

World Cup lifts sentiment (and rents?)

Qatar's success in its bid to host the 2022 World Cup has arguably created a significant wealth effect as expectations of an economic windfall from the games have risen. This is having an impact on asset prices in Qatar and there are suggestions that even housing costs have bottomed out and may, in fact, be on the rise once more. As mentioned earlier, falling rents have had a significant dampening effect on inflation in recent months, so a reversal in that trend could have a significant effect on the overall price level going forward.

At first glance, the World Cup bulls have a lot to cheer about. After all, economic benefits should accrue to a host nation from the following:

- i. investment in productive infrastructure in the build-up to the games, including permanent infrastructure (transportation, accommodation etc.) that will yield a return well beyond the lifespan of the Cup,
- ii. opportunities for local companies in developing this infrastructure,
- iii. boost to tourism and related industries (eg national airlines),
- iv. job creation,
- v. multiplier effect: all the above will result in secondary expenditure in the economy as employment increases and residents experience a wealth effect.

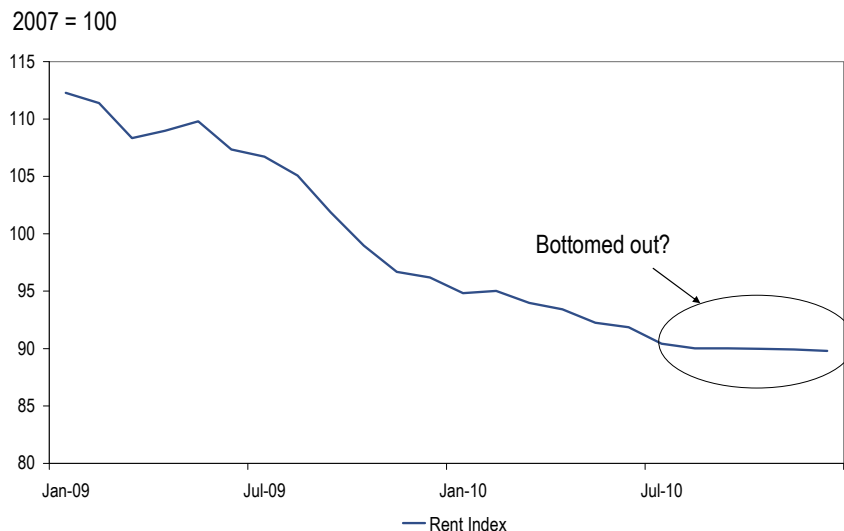
In practice, however, we see the benefits in Qatar's case as being limited by the following factors:

- i. The actual spend on World Cup-specific infrastructure is going to be far less than the reported \$50+ billion,
- ii. The actual spend on World Cup-specific infrastructure is a drop in the ocean compared with projects currently ongoing in Qatar,
- iii. The productivity of the World Cup-specific infrastructure developments is very low, and
- iv. The beneficiaries of increased expenditure on the World Cup will largely be foreigners, with little value-added remaining in Qatar.

For more details on our view of the economic impact of the 2022 World Cup, please see [Qatar Macro View: 2022: Great Expectations, December 10, 2010](#).

Notwithstanding our own skepticism regarding the economic windfall, we recognize that sentiment in Qatar has been lifted by the success of the World Cup bid, and note anecdotal evidence that rents may be on the rise as a result. Indeed, even prior to the outcome of the bid being announced, rental prices were showing signs of stabilizing in Qatar (Figure 3). Given that falling rents have had a significant dampening effect on the overall price level in the past two years, a leveling off in rents will likely mean a pick-up in inflation, with a rise exacerbating price pressures significantly.

Figure 3. Rents may have bottomed out, and may even rise going forward

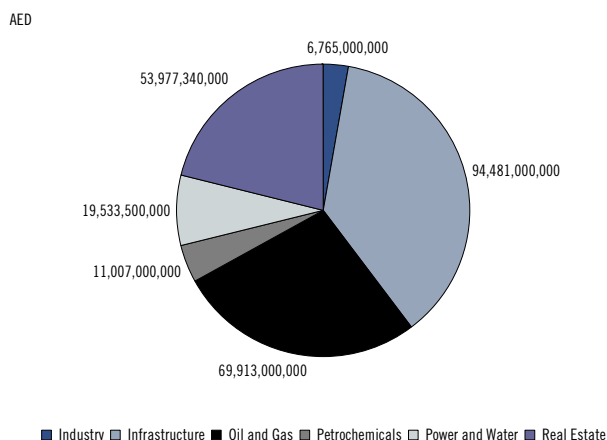


Source: Haver Analytics

Implementation of infrastructure projects will add to pressures

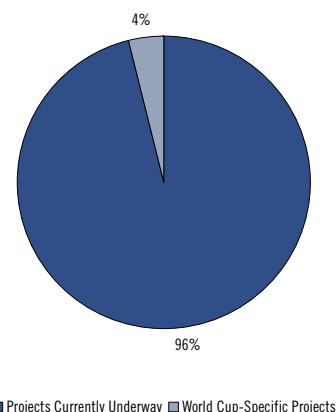
While the direct benefits of the World Cup are limited, an important positive externality of hosting the games is that the prospect of the world's attention being directed firmly towards the Emirate in 2022 will concentrate the minds of the authorities on implementing the \$250 billion of ongoing infrastructure projects (Figure 4). These were previously subject to potential slippage, and are, in our opinion, now more likely to be pushed through to completion in a shorter time frame than may otherwise have been the case.

Figure 4. \$250 bn in ongoing projects in Qatar



Source: Zawya.com, Citi Investment Research and Analysis

Figure 5. World Cup-specific expenditure a drop in the ocean

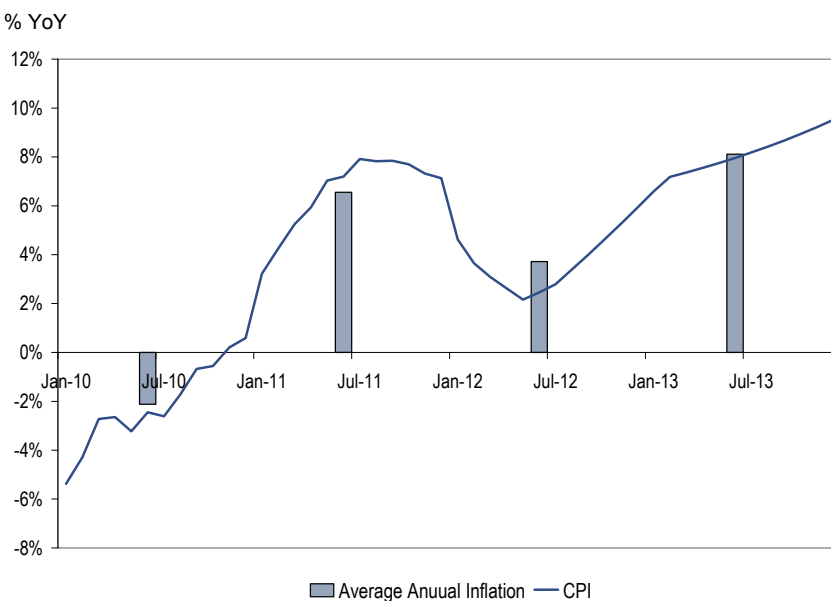


Source: Zawya.com, Citi Investment Research and Analysis

We believe implementation of the planned projects will be a key driver of growth, which we expect will average over 9% per year between 2011-2015. This level of growth is likely to create supply-side bottlenecks, particularly in the construction and transportation sectors, as well as provide a strong impetus to domestic demand, which should also be propelled by a potential recovery in credit growth.

Figure 6 shows our expectations for inflation in the coming 3 years. In 2011, we expect the direct and secondary impact of fuel price hikes, combined with rising global food prices, to raise average annual inflation to around 6%, compared with deflation of -2% in 2010. This will come down somewhat in 2012 as the one-off impact of fuel/food price rises ease, and the base effect takes hold. But the longer-term inflationary pressures associated with project implementation are likely to push prices upward in 2013 (8%) and beyond. This has the potential to create significant policy dilemmas for the Qatari authorities in the medium term.

Figure 6. Inflation will spike in 2011E, but will steadily rise from 2012E onwards



Source: Haver Analytics, CIRA estimates (11-13)

Policy dilemmas and the risk of bubbles

If our view on Qatari inflation materializes, this will present a significant policy dilemma to the Qatari authorities in the medium term. Qatari monetary policy passively shadows that of the US Fed, given the Riyal peg to the dollar. Our view implies a significant divergence in the Qatari and US economic and inflationary outlook, raising questions regarding the appropriateness of a common monetary policy for both countries going forward. This question is not new, of course, and was at the root of speculative inflows into GCC-denominated assets in the lead-up to 2008.

In our view, a rising cost of living in these circumstances will leave the Qatari authorities with three policy options, none of which is particularly favorable.

- They can turn to fiscal tightening to control domestic demand;
- They can de-peg/revalue the Riyal; or
- They can live with high inflation.

The first option looks out of the question given the projects that are on the table and that require completion ahead of the 2022 World Cup. De-pegging/revaluing the Riyal would provide temporary relief through lower cost of imported goods, and would allow greater monetary policy independence to the central bank. However, given Kuwait's experience, it seems unlikely that this would help greatly with home-grown inflationary pressure (eg supply bottlenecks) and the divergence from long-term parity and US monetary policy in practice is likely to be very small. It thus appears to us likely that inflation, if it takes hold as we expect, will remain in place in the long term, until underlying pressures subside.

In our view, the main practical implication of Qatar potentially entering a high inflation period is the risk of asset bubbles forming in the Emirate. On paper, inflation is undesirable for a number of reasons, including creating a disincentive to save/invest, an erosion of competitiveness, and an erosion of standard of living. None of these really apply in the Qatari case, where income levels are high and growing in real terms, and where savings and investment are soaring (mainly in the public sector). But high inflation rates combined with low nominal interest rates (anchored in US policy) should mean that real interest rates revert to being highly negative. This should fuel demand for alternative investment and savings vehicles, prompting strong domestic inflows into local real estate and equity markets, and raising the risk of future bubbles being formed in these markets.

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