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Inflation Pass-through in Saudi Arabia: The Real Issues

Overview

Low and stable prices are key ingredients for economic growth, wellbeing, prosperity and development, as they provide appropriate incentives to all economic agents (consumers, producers, borrowers, lenders, etc.) to engage in meaningful economic activities. In contrast, high and rising prices invoke disproportionate costs on stakeholders. For instance, hyper inflation erodes the purchasing power of incomes, be it nominal wages of households or assets of a business entity or interest incomes. It also leads to a redistribution of wealth away from the poor and to the rich, thereby exacerbating income inequality. Similarly, fixed income earners suffer in relation to flexible income earners, and resources are transferred away from lenders to borrowers. Overall, high and rising inflation could, in itself, trigger a vicious cycle of price instability that could undermine economic growth and socio-political cohesion.

It is therefore not surprising to observe that, nowadays, in Saudi Arabia, as much as in other GCC countries, there is hardly any debate between stakeholders (households, businesses, public servants, students, and policy makers) that does not end without reference to inflation. This contrasts sharply with the past heady days of the oil boom periods of the 1970s and early 1980s when Saudis have enjoyed a period of extremely low, if not negative, inflation. But as Saudi Arabia appears to reap the benefits of high oil prices once again, it is having to grapple with rising food prices and house rental charges that risk widening income inequality and undermining economic growth and competitiveness. Inflation in Saudi Arabia, which more than double to 5 percent in October 2007, from 2.2 percent in 2006, is raising concerns among policy makers, so much so that His Royal Highness King Abdullah summoned officials in August 2007 to explain this phenomenon.

Needless to say, however, many factors are contributing to the current inflationary pressures in Saudi Arabia and other GCC States. These include high global food and commodity prices as well as domestic housing costs, triggered by the high international oil prices and the continuous decline in the value of the dollar vis-à-vis other major currencies. This means that the current inflationary pressure is a global phenomenon, but it is particularly of a greater concern to the GCC States because of their heavy reliance on imported foods and consumer durables and their dollar pegged exchange rate regimes – the only exception is Kuwait which abandoned the dollar peg system in May 2007. But Kuwait cannot escape the global inflation scourge as inflation in Kuwait hit a 15-year high, at 7.3 percent, in November 2007 (Gulf Research Centre, Daily News Alert, 16 December 2007).

The key questions are: what is the nature and composition of inflation in Saudi Arabia? Which index of inflation, 'core' or 'headline' inflation, should be relied upon? How does official inflation differ from the 'inflationary gap' which measures the imbalance between monetary growth and GDP growth? What is the extent of inflation 'pass-through' from imported products? And what policy measures should be put in place to curb inflation in Saudi Arabia and other GCC countries? These and other related questions are addressed in this bulletin.

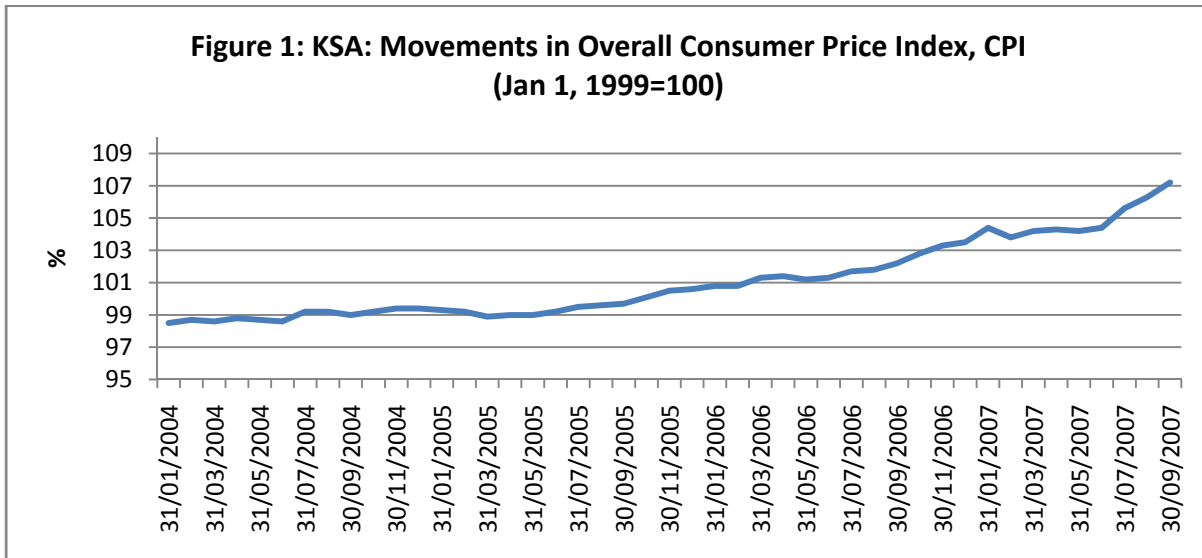
Nature and Composition of Inflation in Saudi Arabia

Since the dawn of the New Millennium, Saudi Arabia has witnessed a rapid increase in consumer prices. The overall index of consumer prices rose by more than eight-fold between 2000 and 2007, driven largely by soaring food prices, housing rents and utility charges as well as medical bills. The consumer price index (CPI) for food and beverages rose by 24 percent during the seven-year period, 2000-2007, averaging 3.4 percent per annum. This is followed by the CPI for housing rent and utility bills, which rose by 12.6 percent (1.8 percent per annum) and that for medical care increased by 8.5 percent (1.21 percent per annum) during the same period (Table 1). The transportation price index showed a negative trend due to King Abdullah's move in decreasing fuel prices for local consumption. However, lack of or very limited cheap public transportation and the significant increase in the prices of car imports reduce the purchasing power of citizen's income for transportation services. The same applies for education, as although free schools are provided by government to locals, however, school requirements from stationary to IT products are rising significantly, which raise concerns over the weights of goods and services calculated in the education price index.

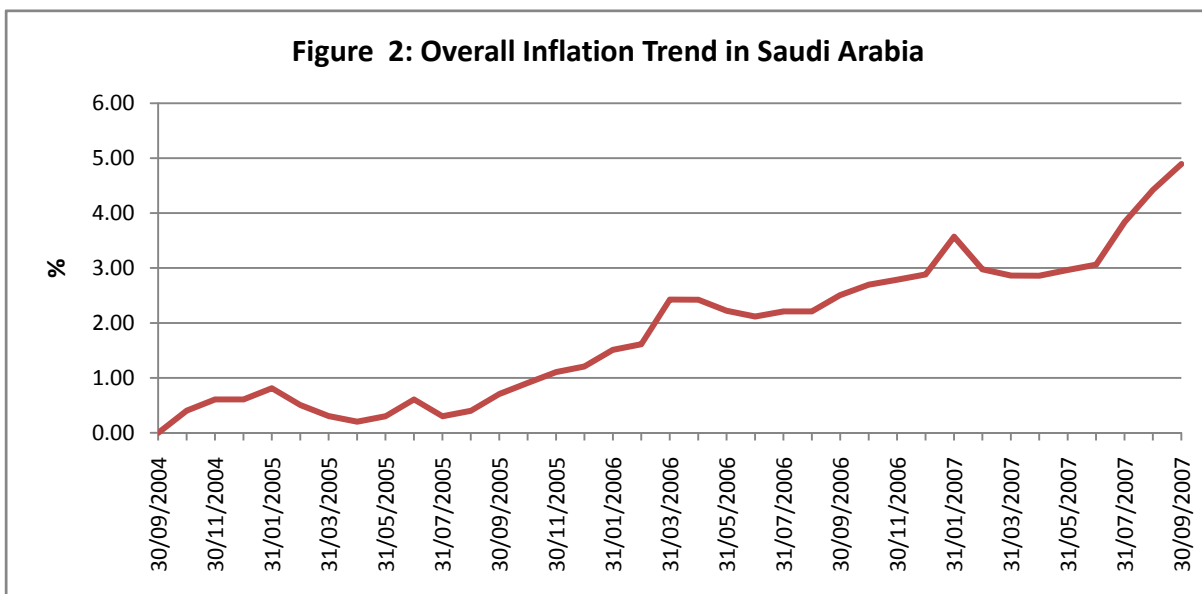
	2000	2007	% change (2000-2007)
Overall Price Index	98.9	107.2	8.39
Food & Beverages	98	121.6	24.08
Fabrics, Clothing & footwear	95	85.1	-10.42
Housing & Utilities	100	112.6	12.60
Home Furniture	98.8	96	-2.83
Medical Care	101.2	109.8	8.50
Transport & Telecom	100.1	88.1	-11.99
Education & Entertainment	99.7	98	-1.71
Other Expenses & Services	99.6	122.9	23.39

Source: SAMA Reports, Reuters, and Gulf One Estimates

These medium term aggregate inflation figures, however, mask considerable yearly or even monthly variations, particularly the recent surge in domestic inflation following the high and increasing prices of global consumer goods. Figures 1 and 2 show the monthly movements in the general consumer price index as well as changes in the general index in Saudi Arabia.



Source: Reuters Database, Saudi Arabia Central Department of Statistics and Information

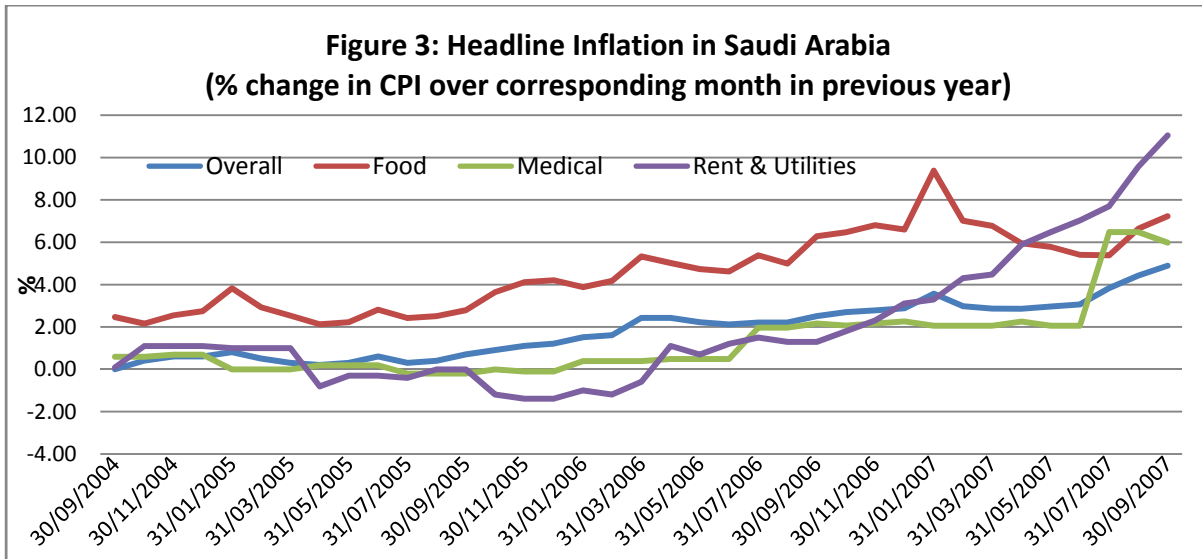


Source: Reuters Database, Saudi Arabia Central Department of Statistics and Information

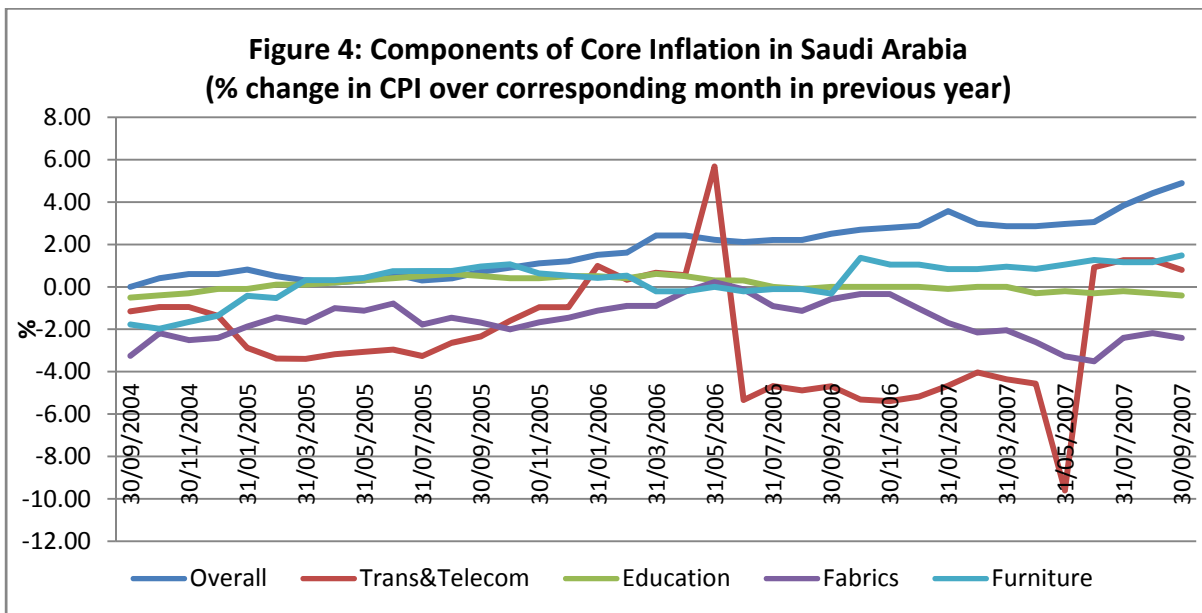
As can be seen from figure 2, inflation in Saudi rose from sub-zero percent in September 2004 to around 5.0 percent in September 2007.

What are the main drivers of inflation in Saudi Arabia? Economists often tend to distinguish two types of inflation: ‘core’ inflation and ‘headline’ inflation. Whilst the former (‘core’ inflation) excludes food and energy costs, the latter (‘headline’ inflation) tracks both food and energy costs. In the case of Saudi Arabia, the headline inflation should be a better indicator of inflation due to the country’s excessive dependence on imported food products

as well as the booming construction activities with associated housing costs and utility charges. It is therefore not surprising to observe that the overall inflationary trend in KSA has been largely dominated by trends in the components of headline inflation, particularly food prices (Figure 3). This contrasts sharply with the trends in core inflation, whose components have consistently increased by less than the increase in the general price index (Figure 4).

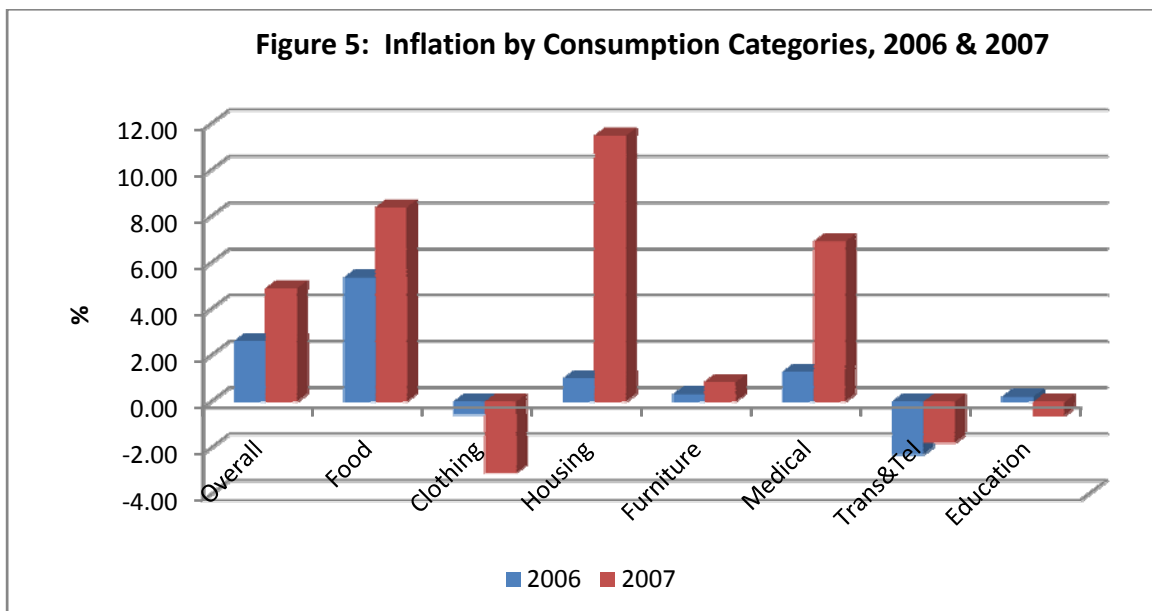


Source: Reuters Database, Saudi Arabia Central Department of Statistics and Information



Source: Reuters Database, Saudi Arabia Central Department of Statistics and Information

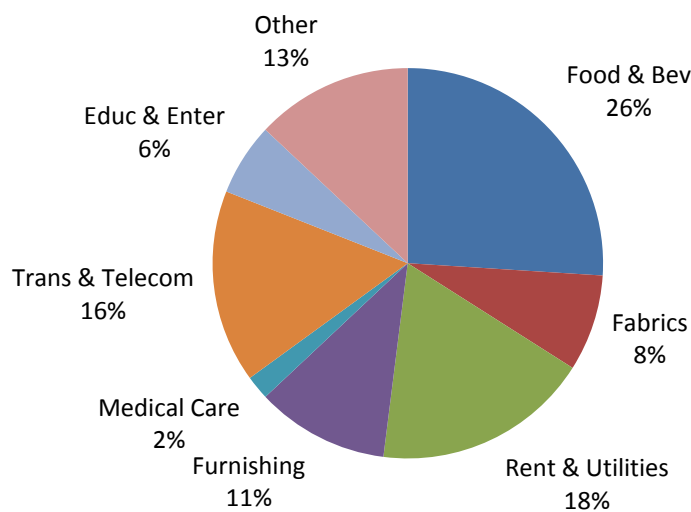
This suggests that understanding the root causes of headline inflation will provide policy makers with perfect insights on how to formulate appropriate policies for dealing decisively with inflation. Although a number of factors have combined in recent years to add to domestic price increases in Saudi Arabia, the recent increases in global food prices as well as metal and construction-related material prices have undoubtedly fuelled inflation in these categories of consumables. For instance, in September 2007 alone, food prices in Saudi Arabia rose by nearly 8 percent, compared with a 5 per cent increase in 2006. Similarly, rents and utility costs increased by a whopping 11 percent in September 2007, as opposed to a mere 1 percent in the same month in 2006. These were followed by medical costs, which have increased by 6 percent in September 2007, compared with a rise of only 1.5 percent in the previous year (Figure 5). In all three categories, however, the rates of inflation in 2007 far exceeded the overall (average) inflation rate of 4.9 percent recorded in September 2007.



Source: Reuters Database, Saudi Arabia Central Department of Statistics and Information

It is noteworthy that the relatively high inflation figures for food and rental charges are to be expected given the sheer weights of these items in the consumption baskets in Saudi Arabia. Latest available data on the composition of consumer price indices shows that food weighs most heavily in the basket with 26%, followed by housing costs (16 percent), and transport and telecommunications (16 percent). See Figure 6.

Figure 6: Consumption Weights in Saudi CPI Basket, September 2007



Source: SAMA, and Saudi Arabia Central Department of Statistics and Information

Given that most consumer goods are being imported, it is inevitable that the current increases in global food prices would fuel domestic food inflation. Similarly, the surge in global prices of steel and other construction materials adds to the soaring construction costs in the Saudi economy, which in turn adds to rental charges, both residential and industrial. In addition, competition for labour among contractors working on multi-billion dollar mega construction projects in the Middle East, coupled with labour shortages, is driving up wages and building costs. Most of the labour force in the construction industry in the Gulf comes from South Asian countries such as India and the Philippines, and impressive economic growth in these countries creates increased demand for labour in their home countries thereby intensifying competitive pressure in the labour market in the Gulf. It is therefore not surprising that construction costs in the Middle East has increased by over 70 per cent in the last five years (Gulf Daily News, 13 December 2007), adding to domestic cost-push inflation.

The key questions are: how does Saudi Arabia's basket of goods and services for inflation compare with those for other countries? Is the basket right or does it have wrong weights with wrong composition of goods and services? The answers to these and related questions are mixed, as with the exception of the UAE, the weights and composition of the CPI baskets for Saudi Arabia are similar to those for other GCC countries and emerging countries, where food and beverages category accounts for the lion's share of the basket. The only noticeable difference is that the share of the food and beverages for Saudi Arabia is much lower than that for Asia's emerging countries, such as India and China. In the case of the developed countries, however, their consumption baskets differ markedly from that for Saudi Arabia. In countries such as France, Germany, and the USA, the consumption basket is largely dominated by housing rents and utility charges— similar to that observed in the UAE. It is only in the UK that the highest weights in the consumption basket go to the Education and Entertainment category (Table 2). In spite of the striking similarities in the weights of the cost of living baskets across countries, it appears that the low weights

accorded to education and medical care categories is puzzling and misleading to say the least.

Table 2: Consumption Weights for Selected Emerging Economies and Developed Countries, 2007 (%)

	US	UK	China	India	Germany	France	Kuwait	UAE	Oman	Qatar	Saudi
Food & Beverages	16	15	33	60	14	18	37	14	30	29	26
Fabrics	4	6	5	9	6	5	10	7	7	11	8
Rent & Utilities	40	12	30	15	30	14	19	36	21	12	18
Furnishing	5	7	3	3	7	6	11	7	5	13	11
Medical Care	5	2	2	3	4	10	*	2	2	1	2
Trans & Telecom	20	18	10	3	16	20	15	15	22	19	16
Educ. & Entert.	6	31	11	3	16	16	3*	10	6	8	6
Others	4	10	6	5	7	11	6	8	6	8	13
Total	100	100	100	100	100	100	100	100	100	100	100

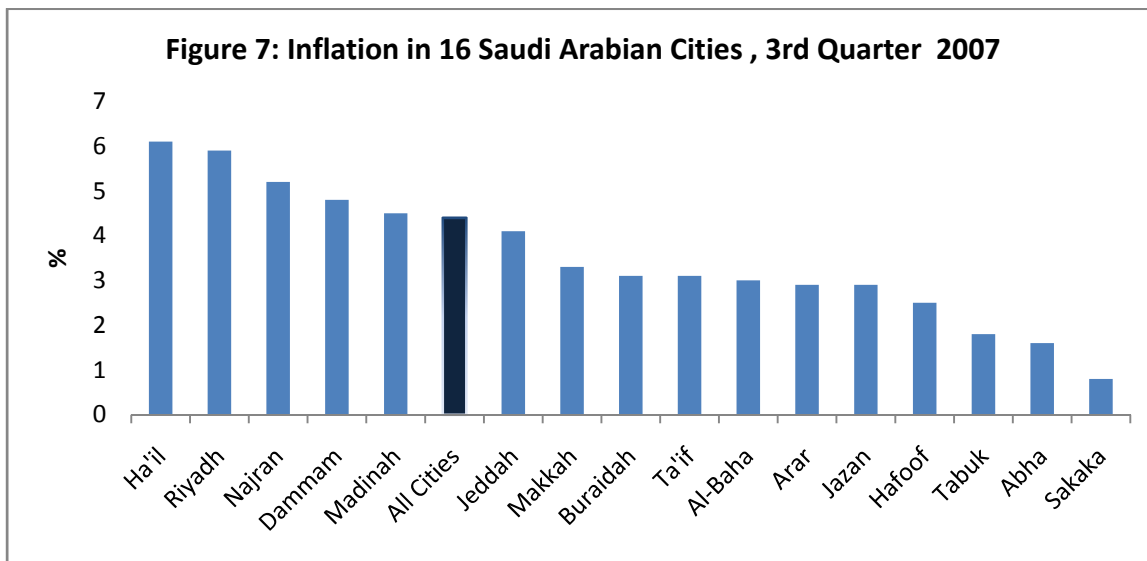
Sources: Monetary and Statistical Authorities of the various countries.

* For Kuwait, the Education & Entertainment category includes Medical Care

Which Are the Most Expensive Cities in the Kingdom?

The inflation in Saudi Arabia is calculated using cost of living index from a basket consisting of 406 commodities across 16 cities. Which of these cities bear the brunt of inflation in the Kingdom? The latest available Inflation Report published by Saudi Arabia Monetary Agency (SAMA) shows that much of the inflation in the Kingdom is on account of 5 cities: Ha'il, Riyadh, Najran, Damman, and Medinah with the first three cities recording the highest inflation rates of 6.1%, 5.9%, and 5.2%, respectively.

Inflation in these five cities in the third quarter of 2007 exceeded the 4.4 percent average inflation rate for the Kingdom (Figure 7). The other cities that have also experienced high inflation figures, albeit slightly below the general index, are Jeddah, Makkah, Buraidah, and Ta'if with inflation rates of 4.4%, 3.3%, 3.1%, and 3.1%, respectively. In contrast, Sakaka has had the lowest inflation rate in Saudi Arabia (0.8%), followed by Abha (1.6%), and Tabuk (1.8%).



Source: SAMA, and Saudi Arabia Central Department of Statistics and Information

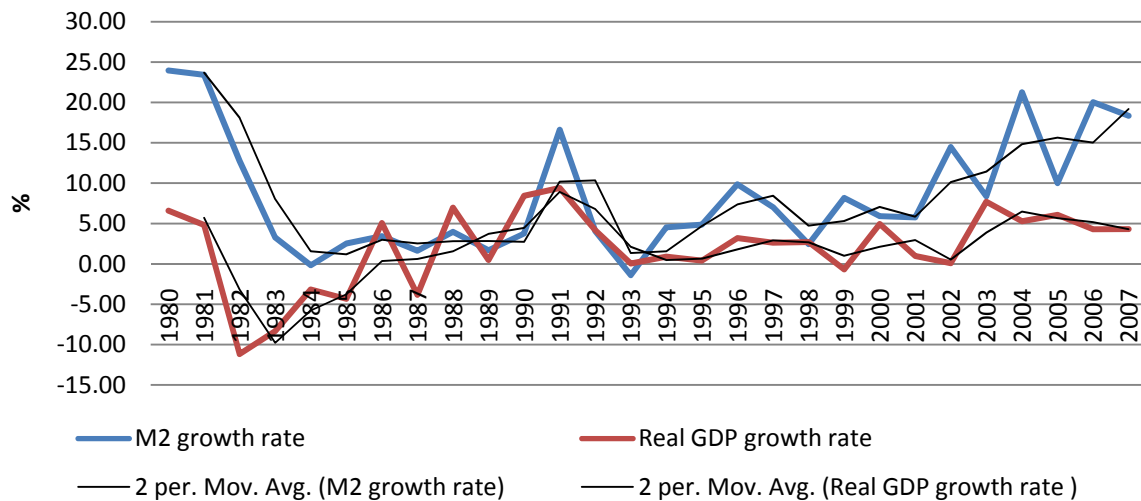
How Big is the Inflationary Gap in KSA?

Although the inflation rates published by official statistical agencies are taken as definitive figures of a country's inflation, they often tend to underestimate the extent of 'real' inflation in a country. From basic monetary economics, there is a direct link between money supply and nominal GDP¹, so much so that growth in money supply should be reflected in GDP growth to ensure that the money supply-GDP equation holds. So, a divergence between monetary growth and GDP growth (when the former exceeds the latter) could provide approximate guide to measuring inflation in any economy.

What does the empirical evidence show in the case of Saudi Arabia? Has GDP growth in the Kingdom matched monetary growth in most of the periods? The answer is NO as Figure 8 illustrates. For the period 1980-2007, monetary growth (measured by the growth rate in broad money supply, M2) has largely exceeded GDP growth rate, even when cyclical fluctuations have been removed by a moving-average process. This provides evidence of the existence of inflationary gaps in Saudi Arabia.

¹ This can be represented by the famous equation $MV=PQ$, where M denotes money supply, V is the velocity at which money changes hands, P is the price level and Q denotes the quantity of goods and services. Of course, this equation depends on a number of assumptions, including full or near to full employment situation and that the velocity of money circulation is relatively invariant.

Figure 8: Saudi Arabia - Growth Rates of Money Supply (M2) and Real GDP

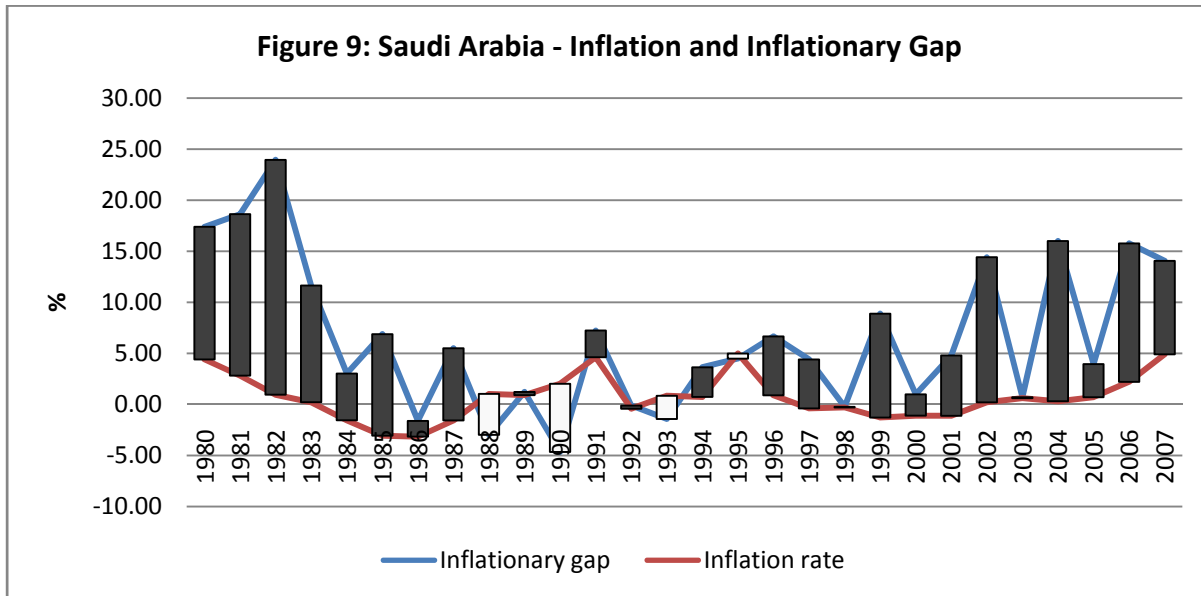


Estimates of the inflation gap for Saudi Arabia, the actual inflation rate and the extent to which the official inflation figures underestimate or overestimate real inflation are shown in Table 3 and Figure 9. Clearly, for all periods (except period average for 1986-1990), the inflationary gap far exceeded official inflation figures, implying gross underestimation of real inflation in Saudi Arabia. The extent of such underestimation is shown in the third column of Table 3 and the solid vertical bars in Figure 9.

Table 3: Inflationary Gap and Inflation Rate in Saudi Arabia

	Inflationary Gap (%)	Inflation Rate (%)	Difference between inflationary gap and inflation rate (%)
1980-1985	13.59	0.62	12.96
1986-1990	-0.51	-0.16	-0.35
1991-1995	2.76	2.15	0.61
1996-2000	4.14	-0.44	4.58
2001	4.79	-1.11	5.90
2002	14.41	0.20	14.21
2003	0.70	0.61	0.09
2004	16.01	0.30	15.71
2005	3.94	0.71	3.23
2006	15.77	2.21	13.56
2007	14.06	4.90	9.16

Source: SAMA and Gulf One Research Department



Source: SAMA and Gulf One Research Department

The relatively large and positive estimates of the inflationary gap for Saudi Arabia can be attributed to several factors. First, it reflects the ‘lag effect’ of monetary transmission mechanism on the real sector of the economy. Secondly, it simply underlines the implicit inefficiency in the money supply transmission mechanism. Thirdly, it brings out the inherent weaknesses of some of the assumptions of the ‘quantity theory of money’, especially those relating to the velocity of money supply and full employment output hypotheses, given the current high level of employment in the Kingdom and the invariant nature of money supply velocity in the economy.

In spite of all this, the Saudi experience bears resemblance with situations in most GCC countries as well as in other emerging economies and developed countries. Within the GCC countries, for example, all countries (except Kuwait and Qatar) had inflationary gaps greater than inflation rates in 2007 (Table 4 and Appendix Table). Outside the GCC region, however, only China and Germany had negative inflationary gaps, demonstrating the effectiveness and efficiency of their monetary policies in promoting economic growth. In contrast, in both emerging economies, such as India, and advanced market economies such as the France, the UK and USA inflationary gaps exceeded actual inflation figures by wide margins (Table 4).

Table 4: Inflationary Gaps and Inflation Rates in GCC and Selected Countries, 2007

	Inflationary Gap (%)	Inflation Rate (%)
Bahrain	10.81	3.3
Kuwait	3.10	4.4
Oman	20.49	4.4
Qatar	-0.24	12.20
Saudi Arabia	14.06	4.4
United Arab Emirates	28.11	10.1
China	-18.56	4.5
India	11.52	6.2
France	10.17	1.6
Germany	-5.94	2.1
UK	9.63	2.4
USA	3.95	2.7

Source: Monetary Authorities of each country; IMF, World Economic Outlook 2007 Database

Is All to do with Imported Inflation: Estimates of Inflation Pass-through in Saudi Arabia

As already stated earlier, one of the main sources of the recent inflationary situation in Saudi Arabia is attributed to imported inflation. If so, how large is the contribution of imported inflation to domestic inflation in the Kingdom? Which sources of imports tend to propel domestic inflation much more substantially?

There are a number of techniques that have been used to estimate the extent of imported inflation. One such method simply combines a country's shares of imports and inflation rates in import-source countries to provide estimates of inflation pass-through in an importing country. Figures 10a-10c provide a vivid illustration of this technique for Saudi Arabia. Figure 10a shows the Kingdom's shares of imports from various sources in 2007 -- the Eurozone accounted for nearly 24% of Saudi Arabia's total imports, followed by the USA (14.5%), China (8.6%) and Japan (8.1%). However, inflation in the Eurozone in 2007 was 2.2%, USA (3.2%), China (1.5%) and Japan (0.2%)(Figure 10b). Combining the import shares and source-country inflation yields import-weighted shares of inflation to ascertain the extent to which imports from various sources contribute to domestic inflation. Figure 10c shows the contribution of source country imports to domestic inflation in Saudi Arabia. As can be seen, the Eurozone accounted for 32% of inflation in Saudi Arabia in 2007, followed by the USA (28%), India (14%) and China (8%). In contrast, Japan accounted for only 1%, South Korea (5%), and the UK and Australia each contributing 6% (Figure 10c).

Figure 10a: Main Sources of Imports, 2007

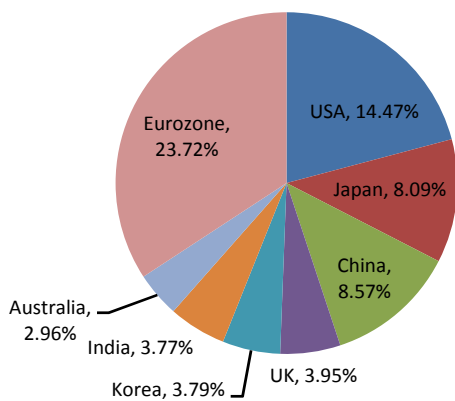


Figure 10b: Inflation in Saudi Arabia's Main Trading Partners, 2007 (%)

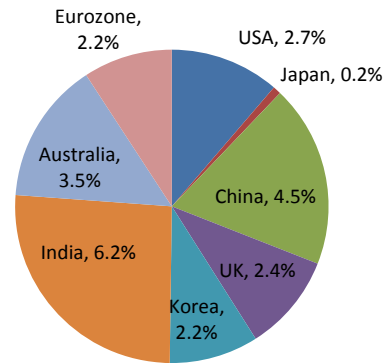
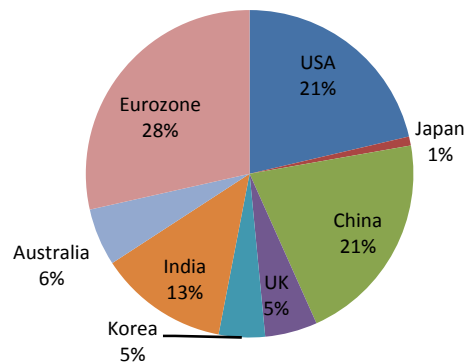


Figure 10c: Saudi Arabia: Share of Imported Inflation by Import Sources, 2007

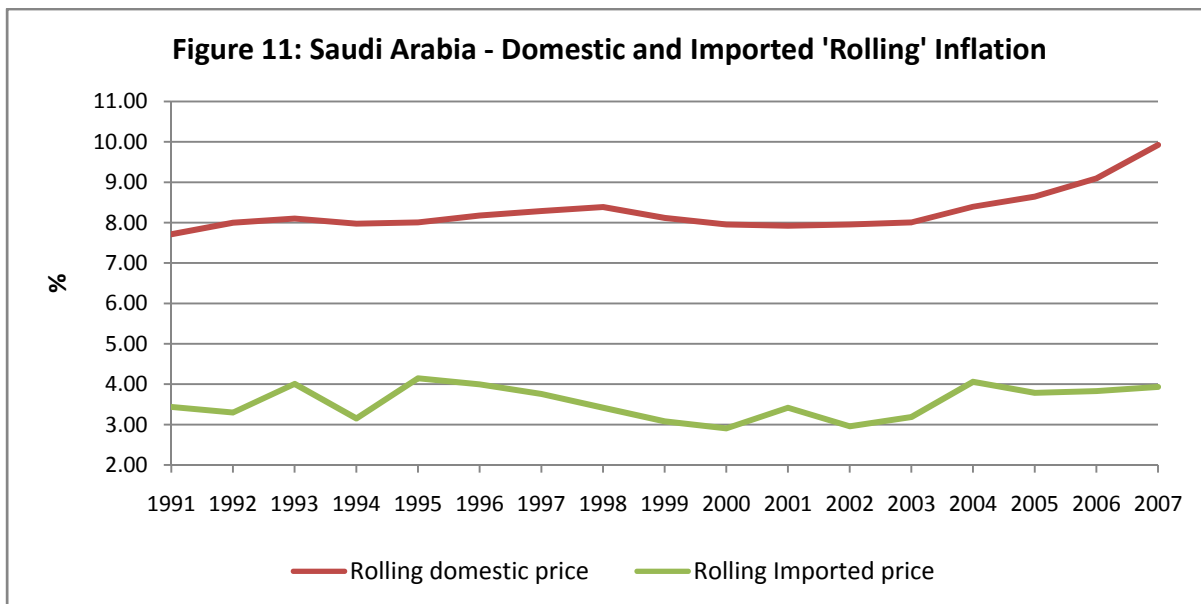


Estimates of Inflation Pass-Through for Food in Saudi Arabia

Utilising the above technique to estimate overall inflation pass-through is, however, simplistic and masks considerable variation in individual import components. Given that the main driver of Saudi inflation over the past decade or so was food inflation, and given the recent rise in global food prices, it is appropriate to apply a much complex and detailed technique to estimating the inflation pass-through on Saudi food inflation.

This methodology is based on three stages. The first stage involves calculating domestic and imported inflation using both domestic CPI and import CPI for food products. The second stage involves calculation of what is called 'rolling' inflation for both domestic and imported food prices². In the third stage, the inflation pass-through is calculated as the difference between the rolling domestic inflation rate and the rolling import price of food expressed as a percentage of rolling domestic inflation rate.

Figure 11 shows the calculated rolling inflation for both Saudi Arabia's domestic food inflation rate and import food price. The gap between the domestic price and the import price, expressed as a percentage of the domestic rolling food price, represents the extent of the inflation pass-through on food products in Saudi Arabia. As can be seen from Table 5 and Figure 12, over 60% of the domestic food prices in Saudi Arabia in 2007 was on account of imported food items, up from 47% in 2003.



Source: FAO Database, SAMA, Gulf One Research Department

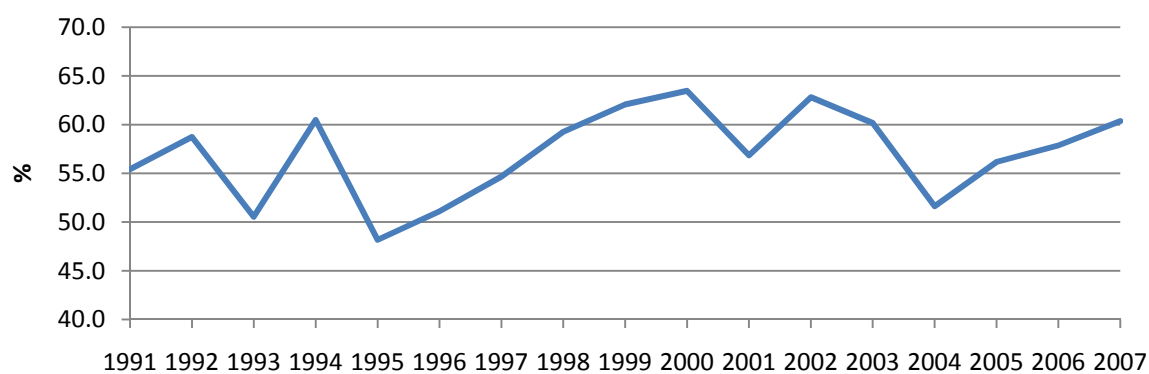
² The rolling inflation technique is synonymous but not identical to cumulative inflation. It is defined as $X_n = X_{n-1}(1 + Y_n)$ where Y is actual inflation rate and X is rolling inflation rate.

Table 5: Saudi Arabia's Food Inflation and Inflation Pass-Through from Imported Food Products

	Food Inflation Rate (%)	Food Inflation pass-through (%)
1991	7.43	55.42
1992	3.62	47.78
1993	1.31	59.48
1994	-1.62	45.78
1995	0.41	47.97
1996	2.11	52.10
1997	1.38	57.05
1998	1.17	61.74
1999	-3.25	62.70
2000	-2.02	55.22
2001	-0.41	61.10
2002	0.41	58.25
2003	0.61	47.15
2004	4.75	52.97
2005	2.95	54.34
2006	5.21	57.91
2007	7.23	60.41

Source: FAO Database, SAMA, Gulf One Research Department

Figure 12: Saudi Arabia - Imported Inflation pass-through (% of domestic food inflation)



Source: FAO Database, SAMA, Gulf One Research Department

Policy Issues

A recent opinion poll conducted by Reuters in the GCC countries paints a bleak inflation outlook for Saudi Arabia in 2008 (Reuters, 13 December 2007). Although inflation in some GCC countries, particularly Qatar and the UAE, is higher than inflation in Saudi Arabia, the results of the poll singled out Saudi Arabia as the only country that risks facing accelerating inflation in the coming year. Clearly, this calls for immediate policy action to nip the inflation in the bud before it spirals out of control.

However, the policy options at the disposal of policy makers may seem to be limited given the multi-faceted nature of inflation. Theoretically, it is argued, the best way to control inflation is to identify the root causes of inflation, but in the case of Saudi Arabia and other GCC countries with the dollar-peg exchange rate regimes, their options may be limited as strong growth, rising rents and weakening dollar fuel inflation to new heights. As prices continue to rise, the debate would continue to intensify about the GCC's currency pegs to the dollar. Thus, ditching the currency peg system would give a big boost to policy makers in their bid to curb inflation. In the absence of a move away from the fixed dollar peg scheme, however, the authorities would have to increasingly rely on fiscal policy measures including price control and subsidies.

Recently, Saudi Arabia introduced subsidies on imported rice and baby milk, as ordered by the Custodians of the two Holy Mosques, King Abdullah. Although this might help to cushion consumers from inflation in the short run, subsidies may not be enough to keep inflation in Saudi Arabia at bay; it must be complemented with long term policy initiatives. One such measure requires a purposeful articulation and formulation of policies for accelerating the diversification of the economic base of the Kingdom and other GCC states.

Another policy option is to introduce an inflation-indexed rule for periodic increases in house rents and utility charges to curb the rising cost of living associated with this category of consumer spending. Yet another policy measure is to hasten the process of abandoning the currency peg to give the monetary authorities autonomy and independence to set appropriate exchange rate and interest rate policies to control inflation instead of constantly tracking monetary policy in the US whose economic cycle is currently out of sync with that in the GCC region.

So long as monetary policy instruments for controlling inflation are 'untouchable', thanks to the pegged exchange rate system, reliance on fiscal policy measures and controls are unlikely to prove effective in tackling inflation in an era of economic boom. Perhaps, the only option to curb inflation is to learn how to live with inflation!

Appendix Table: Inflationary Gap and Inflation Rates in Other GCC Countries

Bahrain			
Period	Inflation Gap (%)	Inflation Rate (%)	Difference between Inflation Gap and Inflation rate (%)
1981-1985	21.97	4.18	17.79
1986-1990	-3.74	-0.74	-3.00
1991-1995	2.48	1.34	1.14
1996-2000	5.17	0.40	4.77
2001	4.60	-1.20	5.80
2002	5.14	-0.50	5.64
2003	-0.79	1.70	-2.49
2004	-1.30	2.30	-3.60
2005	14.08	2.60	11.48
2006	7.13	3.00	4.13
2007	10.81	3.30	7.51

Kuwait			
Period	Inflation Gap (%)	Inflation Rate (%)	Difference between Inflation Gap and Inflation rate (%)
1981-1985	17.48	4.52	12.96
1986-1990	-4.49	4.46	-8.05
1991-1995	-26.38	2.66	-23.76
1996-2000	1.80	1.82	-0.02
2001	12.58	1.40	11.18
2002	1.73	0.80	0.93
2003	-8.69	1.00	-9.69
2004	1.56	1.30	0.26
2005	2.32	4.10	-1.78
2006	15.42	3.00	12.42
2007	3.10	4.40	-1.30

Oman			
Period	Inflation Gap (%)	Inflation Rate (%)	Difference between Inflation Gap and Inflation rate (%)
1981-1985	9.87	-0.92	10.79
1986-1990	1.81	4.68	-2.87
1991-1995	-0.63	0.98	-1.61
1996-2000	6.55	-0.04	6.59
2001	1.71	-0.80	2.51
2002	2.92	-0.30	3.22
2003	0.64	0.20	0.44
2004	-1.83	0.70	-2.53
2005	15.51	1.90	13.61

2006	18.72	3.20	15.52
2007	20.49	4.40	16.09

Period	Qatar		
	Inflation Gap (%)	Inflation Rate (%)	Difference between Inflation Gap and Inflation rate (%)
1981-1985	16.52	3.82	12.70
1986-1990	0.72	3.80	-3.08
1991-1995	3.85	1.88	1.97
1996-2000	-0.46	3.34	-3.80
2001	-6.31	1.40	-7.71
2002	4.66	0.20	4.46
2003	12.30	2.30	10.00
2004	-0.30	6.80	-7.10
2005	37.11	8.80	28.31
2006	29.12	11.80	17.32
2007	-0.24	12.20	-12.44

Period	United Arab Emirates		
	Inflation Gap (%)	Inflation Rate (%)	Difference between Inflation Gap and Inflation rate (%)
1981-1985	18.25	4.44	13.81
1986-1990	0.00	3.86	-3.86
1991-1995	2.51	5.02	-2.51
1996-2000	2.87	2.28	0.59
2001	19.75	2.80	16.95
2002	9.20	2.90	6.30
2003	3.64	3.10	0.54
2004	16.42	5.00	11.42
2005	22.03	7.80	14.23
2006	-2.28	10.10	-12.38
2007	28.11	10.10	18.01

Source: Monetary Authorities of the GCC Countries, Reuters and Gulf One Research Department

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