Inflation in the GCC: An Analysis of the Causes and Implications for Monetary Policy

In DIFC Economic Note 5 on "Inflation in the GCC", we have conducted an empirical analysis of inflation in the GCC countries over the period 1980 to 2008, using quarterly data. In our analysis seeking to determine the factors influencing inflationary pressures in the GCC countries, money supply in the region comes up as the foremost factor. In fact, the Vector Auto Regression analysis – starting with a simple three variable model and expanded to more complex specifications – highlights that even when we look simultaneously at variables such as the exchange rate and commodity prices, the influence of money supply shocks predominates in the inflationary process.

International factors such as the foreign exchange rate, and food and raw material prices (which were rising in the first half of 2008) historically have had less influence on inflation in the GCC region. Monetary fluctuations are the major determinant of inflation fluctuations in the GCC over the period 1980-2008. Our results imply that monetary stabilisation and control is at the root of the control and stabilisation of inflation.

The results highlight first and foremost the importance of an independent monetary policy. Given the region's peg to the dollar (with the exception of Kuwait), the GCC central banks have been forced to mirror the Fed's monetary policy cycle with real interest rates turning negative at times; this has, in turn, led to an increase in domestic lending, which resulted in excess liquidity, fuelling domestic inflation further. Containing inflationary pressures would have required putting a lid on domestic demand, addressing the non-tradables inflation and easing supply bottlenecks (e.g. the real estate sector) through a tighter monetary policy, which the peg to the dollar prevented.