AB WEEKLY ECONOMIC MONITOR

Volume 1, Issue 9, 18 May 2008

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Oil Prices, The Dollar-peg and Inflation

On the face of it, the recent coupling between rising oil prices and sliding value of US dollar is creating asymmetric impact on many global economies. While our oil-rich region has been roaring with economic growth, driven mainly by high and rising oil and gas prices, an emerging area of malaise pertains to rapidly rising inflation. For oil importers like Jordan, the impact has been in terms of rising energy import bills, unfavorable fiscal balance and increased production cost.

In fact, domestic inflation rates in our region have leaped upwards so much that inflation in Saudi Arabia has recently inched up to 8 percent, up from under one percent in 2002. Interestingly, the inflation rates in Germany, UK and the US are respectively 2.4%, 2.6% and 3%, fractions of those in KSA, UAE and Jordan.

Rising domestic inflation has heated debate about the merits of pegging local currencies to the US dollar. The crux of the argument for currency de-pegging is that the sliding dollar makes imports from Europe and some Asian countries more expensive which cause domestic inflation rates to trend upwards.

However, the connection between domestic inflation and the dollar peg is at least partially misplaced because it fails to take into consideration the relative contributions of various domestic and international factors behind the emergence of high inflation rates. First is the sizzling economic growth which puts pressure on prices to go up. Secondly, the fiscal policy in the GCC tends to be pro-cyclical; that is, governments spend more and employ more workers and pay higher wags as they reap more revenues from the high and rising oil prices. Pro-cyclical expansionary fiscal policy puts upward pressures on prices.

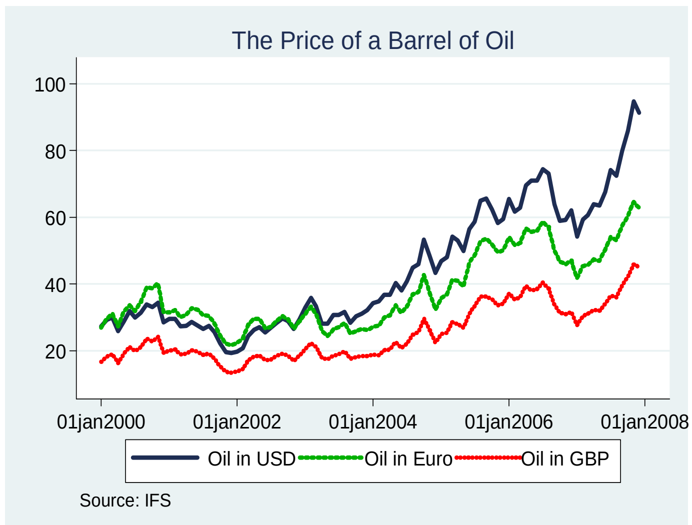
Internationally- rising food prices also contribute to the rising inflation in the GCC economies. In the face of water shortages and rapid population growth along with firm adherence to WTO commitments that call for repealing of grain, including wheat, subsidies, the GCC economies are becoming more vulnerable to rising global food prices. In fact, food is one of the fastest-growing components of inflation in the GCC economies. In a bid to ensure long-term food security plans, KSA is seeking to outsource agricultural investments to invest in farms in Thailand. The plan is for out-sourced rice production to be shipped to KSA, with any surplus to neighboring countries in the Gulf region (OBG, May 15, 08).

Sliding dollar crops up the argument that the dollar-peg causes monetary policy to become ineffective and basically follow that of the Fed. Taken at face value, this argument implies that in order to mitigate rising inflation, the recipe for central banks is to raise interest rates. However, with globally-rising prices of agricultural and food commodities, it is not clear how tightening domestic monetary policy could help cut prices of imported agricultural crops and food products such as rice from India which recently imposed restrictions on basmati rice exports. In fact, for countries that import fuels and foodstuffs, it is plausible that a policy decision of raising interest rates could only exacerbate the problem because interest rates are a form of costs to the producers. As interest rates increase, the costs of borrowing increase and thereby overall production costs trend upwards. To the extent possible producers would try to pass the rising costs onto consumers in the form of higher prices.

Assuming the recipe is correct, the question is by how much should monetary policy increase interest rates in order to bring down inflation to say 3% in Saudi Arabia or Jordan? This is even a tougher question to address not only because of the time lags that will elapse before such policy measures become effective, but also because the increase in interest rates that is required to decelerate inflation might very well be substantial to the extent that it would slow down economic growth by discouraging private sector investments.

Aside from the above, there is an important consideration that affects the perspective of the GCC economies towards the dollar. When the dollar depreciates relative to Asian and European currency, the EURO, GBP, the dollar-priced oil becomes cheaper in the respective currencies of the Asian and European countries. Figure 1 below shows the increasingly widening gap in the price of a barrel of oil in three currencies.

Figure 1



ARAB BANK

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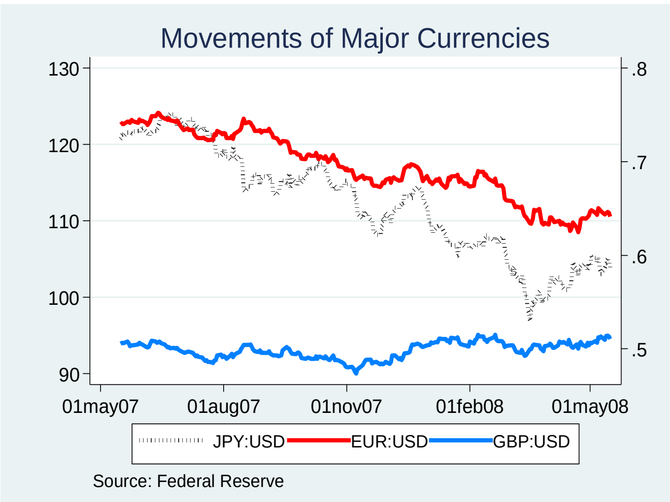
Global Developments

The US dollar continues its depreciation against the Euro and the Yen after US consumer confidence fell to its lowest levels in 28 years and oil prices continued to break records. In the UK, declines in retail sales and house prices as well as worries over the mounting inflation caused the British Pound to drop against the US Dollar[1].

Figure 2



Oil prices were quite volatile on Friday. Crude oil rose above $127/bbl for the first time on Friday due to Goldman Sachs raising its price forecasts and anticipation that China will increase its energy demands after the massive earthquake. However, Saudi Arabia's announcement that it will increase production led prices to settle at $126.3/bbl. The surging oil prices as well as the weakening dollar caused gold to appreciate the most in 10 weeks. In contrast, rice prices fell as exports from Japan and Pakistan relieved worries over a global food crisis[2].

Table 1 Selected Commodity Prices

	Week ending 5/9/2008	Week ending 5/16/2008	Change
Oil WTI ($/bbl)	125.97	**126.30**	**0.26%**
Gold ($/oz)	876	**897**	**2.40%**
Natural Gas	11.29	**11.25**	**(0.34%)**

Source: WSJ

Although global markets rebounded strongly this week, the US markets were nevertheless affected by the US consumer confidence decline. In Europe, equity markets rose, especially in the UK where stocks rose to their highest level in 4 months with British Airways and British Energy leading the stock rally. In Asia, markets went up as speculation grew that China is looking for outside acquisitions in order to satisfy its mounting consumer demand.[3]

After last week's strong performance, the ASE index was mixed recording an increase of 0.24% at the end of the week. In the GCC, the Saudi capital market also rose slightly after last week's bearish run. In contrast, the Egyptian market fell by 12% dragged down by leading shares as sales of Arab and foreign investors amounted to 4 million Egyptian Pounds[4].

Table 2 Selected Market Indices

Index	Week ending 5/9/2008	Week ending 5/16/2008	Change
Jordan	9247	**9,269**	0.24%
KSA	9771.85	**9,783.19**	0.12%
Morocco	14,470.19	**14,543.73**	0.51%
S&P500	1,388.28	**1,424.58**	2.61%
NIKKEI	13,655.34	**14,219.48**	4.13%
FTSE100	6,204.70	**6,304.30**	1.61%

Sources: Bloomberg and Official Markets

Did You Know?

- The world public broadly embraces key tenets of globalization but fears the downside of international immigration and threats to the environment (Global Project Attitudes, Oct 07).
- In Jordan, the general industrial production index rose by 7.7% per cent during the first quarter of 2008 compared with 2007 Q1? (DOS, 08)
- Natural gas is becoming increasingly short in the GCC countries, but Oman is also past peak oil, which means less production of associated gas (MEED, May, 2008).
- Chinese inflation reached 8.7% in March 2008 driven by 49% rise in meat and poultry prices. Surging crude oil prices pushed up the producer price index by 6.6% in February 2008 (The Banker, April 2008)

INFORMATION

AB Weekly Economic Monitor provides weekly review of information and regional development. The weekly is authored by Dr.Sulayman Al-Qudsi, Chief Economist, AB Plc. Jordan

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Research Department at AB, Jordan Headquarters.

[1] FT, Bloomberg and Others
[2] FT, Arabian Business and Others
[3] FT and Others
[4] Egyptian Radio and Television Union News, 17 May 2008