Special Comment

Moody's Global Sovereign

June 2008

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Middle East: Resurgent inflation sharpens fiscal and political risks

Summary

The Middle East is experiencing a strong resurgence of inflation. While accelerating price growth is a global phenomenon, the Middle East region has been particularly affected because of a preponderance of fixed or heavily managed exchange rates, an oil-fueled liquidity expansion, widespread infrastructure bottlenecks, and a reliance in most countries on food imports. Of all the IMF's regional groupings, the Middle East experienced the highest average inflation rate in 2007, at 10.4%, and this is expected to accelerate in 2008.

Although inflation is seldom a direct driver of Moody's ratings, it can affect ratings indirectly through three main channels – fiscal, political, and economic. We are beginning to observe these trends in the Middle East. Given enhanced sensitivities to the risk of social unrest, some governments are finding it difficult to maintain fiscal discipline. Inflation's tendency to aggravate political risk is clearly less acute among oil exporters, who currently have the capacity to expand fiscal expenditure and offset the erosion of citizens' purchasing power. Poorer countries have less room for manoeuvre, however, and hence the political and fiscal consequences of inflation are of greater short-term concern. Although accelerating inflation has yet to impact real growth in the region, which remains strong, there is a risk that it could undermine activity if sustained.

We have constructed a simple and non-linear rank ordering of the countries we rate in the Middle East to show their relative ratings sensitivity to the effects of inflation. We have based this on three primary considerations – social vulnerability, fiscal flexibility, and inflationary pressure. As would be expected, the ratings of non-oil exporting countries that are poorer, fiscally constrained, and already experiencing high rates of inflation are more likely to be affected in the shorter term than the ratings of the more affluent Gulf oil-exporters. High rates of inflation are of particular concern in Egypt (whose Baa3 local currency rating is on negative outlook) and Jordan given their social and fiscal vulnerabilities. Lebanon's very low B3 rating already encapsulates a high degree of political and economic risk.

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Middle East: Resurgent inflation sharpens fiscal and political risks

Inflation can affect ratings indirectly through three main channels

Historically, inflation has not been a direct driver of changes in Moody's sovereign credit ratings. There is an apparent correlation between the rate of inflation and the rating level, with higher rated countries tending to have lower inflation. Yet this is largely symptomatic. Higher rated countries tend to have a better quality of economic management, more robust institutions, and a more sophisticated monetary policy that often targets inflation specifically. Lower rated countries usually have a weaker policy framework, are more vulnerable to currency crises or other economic shocks, and therefore are more prone to inflation.

High rates of inflation can have indirect rating consequences, however. These tend to operate through three main channels:

1. Fiscal – Inflation, if unanticipated, can have a beneficial effect on a government's debt burden as the stock of local currency debt is eroded in real terms. This played a role in the past when some countries (e.g. some Latin American countries in the 1980's) attempted to "inflate their debt away". This effect is often offset over the longer term, however, by a range of negative developments. Governments can find it difficult to maintain fiscal discipline during inflationary periods as citizens demand compensatory increases in salaries, subsidies, and welfare payments to offset their decaying purchasing power. Governments' creditors can demand higher and more flexible interest rates. Inflation can also undermine confidence and cause an exchange rate depreciation which can swell the cost of servicing foreign currency debt in local currency terms.
2. Political – High rates of inflation often raise social tensions as the purchasing power of citizens, especially those on lower incomes, is undermined. Governments and public and private employers are sometimes reluctant to raise wages, subsidies, and welfare payments quickly enough in order to offset this, partly because of a justified fear that such increases will exacerbate inflationary pressures and lead to further demands. The social impact of inflation can be particularly harmful if surging inflation damages the real sector and causes higher unemployment.
3. Economic – High rates of inflation can jeopardize growth by deterring productive investment, perverting market incentives, encouraging wage hikes, and disrupting activity through strikes or more serious political unrest. The free functioning of markets can also be hampered by the introduction of unorthodox economic measures such as price controls as governments attempt to stem inflation through alternative means.

Middle East was the most inflationary region in 2007

According to the IMF, the Middle East experienced the highest average level of inflation in 2007 out of any region globally and it is expected to have the second highest average inflation rate in 2008 after the CIS (see chart 1). In 2007, the region's inflation rate averaged 10.4%. This was almost double the emerging market average of 6.4% and the region's rate of price growth is again expected to be significantly higher than the emerging market average in 2008. The last year in which the region's average inflation rate exceeded 10% was in 1995.

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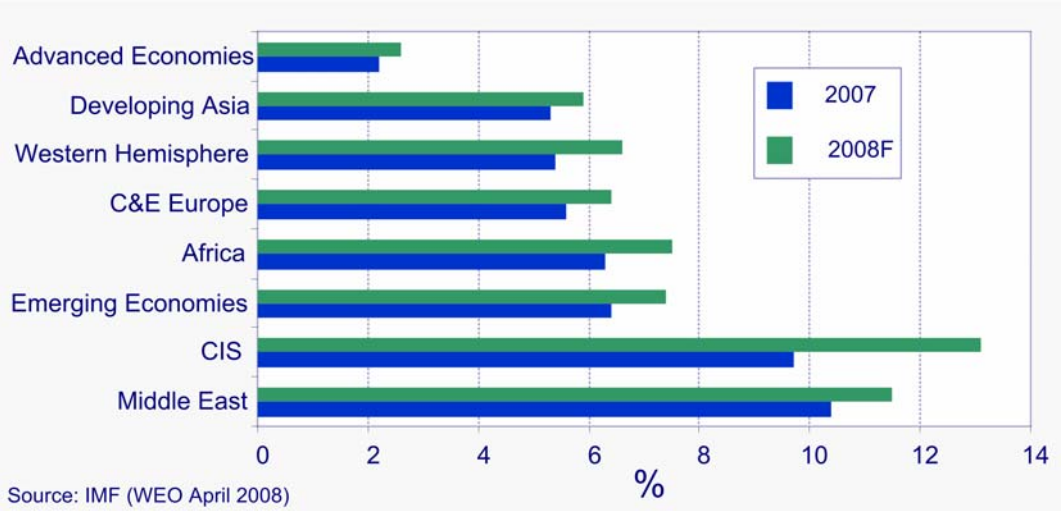
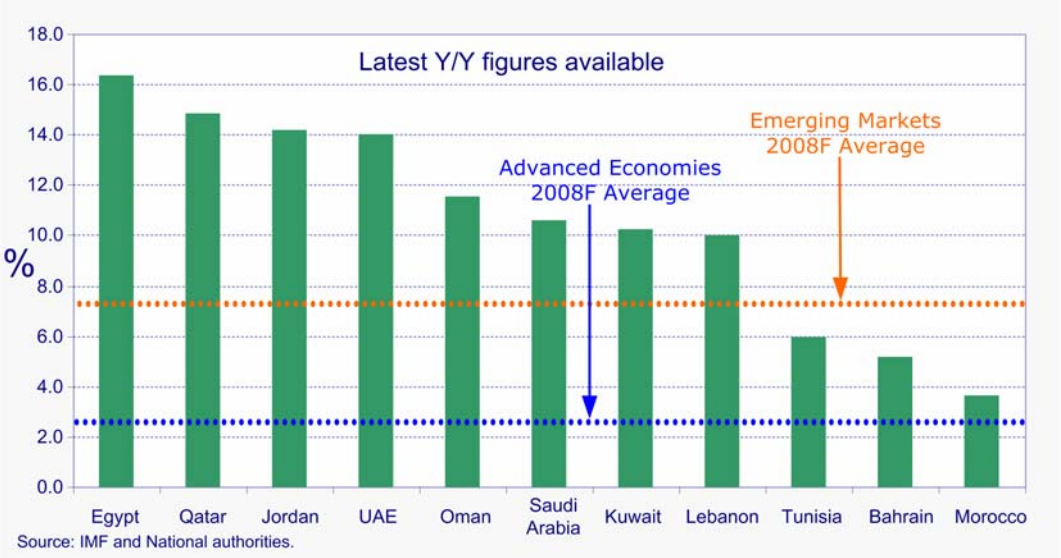
Chart 1 – Regional inflation rates



Inflation currently ranges from a high around 16% in Egypt to 4% in Morocco

While inflation is accelerating in nearly all countries, there is a broad variation in inflation rates among those countries that Moody's rates in the region (see chart 2). According to the latest reported data, year-on-year inflation ranges from a high of 16.4% in Egypt (April) to a low of 3.7% in Morocco (April). Nevertheless, inflation currently exceeds the emerging market average, of around seven percent, in eight out of the eleven countries that Moody's rates in the Middle East.

Chart 2 – Monthly inflation rates



Many drivers of inflation are exogenous

Middle Eastern countries are inevitably subject to similar inflationary pressures that are affecting other regions, most importantly rising international commodity prices. Import prices of food, fuel, and metal have all soared over the past five years and the price of commodities continues to accelerate (see Chart 3). Many Middle

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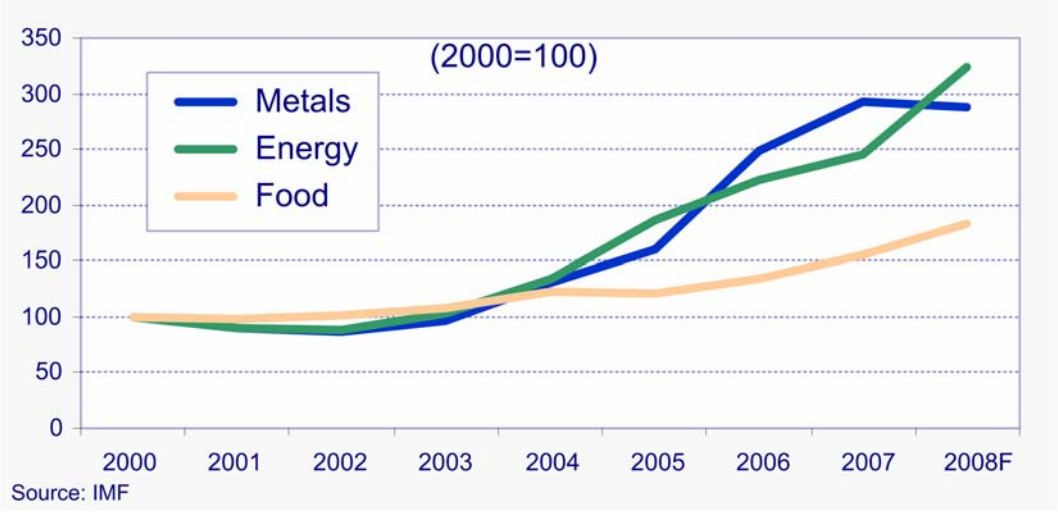
Eastern countries, particularly those in the Gulf region, are highly reliant on food imports given their harsh climates and underdeveloped agricultural sectors.

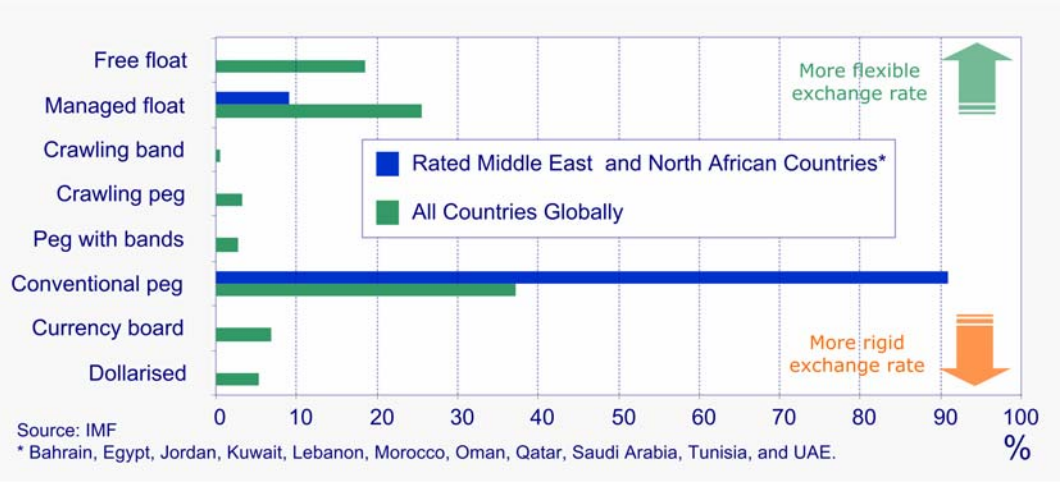
Chart 3 – Global $ commodity price indices



Pegged exchange rates are a contributing factor

The effect of exogenous inflation drivers on domestic prices in Middle Eastern states has been exacerbated by a preponderance of dollar pegged exchange rates. Exchange rate policy in the Middle East region is generally less flexible than in other regions (see Chart 4). Just over 90% of (or 10 out of 11) countries that Moody's rates in the Middle East region have conventional currency pegs according to the IMF's classification. Globally, the percentage of countries with either conventional pegs or more rigid exchange rates is just under half.

Chart 4 – Exchange rate policies



With the exception of Morocco and Tunisia (whose currencies are linked to the euro), most currencies in the region are linked to the US dollar. The weakening of trade-weighted nominal exchange rates in line with the US dollar has tended to amplify the effects of imported inflation in these countries. Likewise, dollar pegs have acted as a shackle on monetary policy, requiring that interest rates be loosened in line with US rates. This has led to substantially negative real interest rates in most Middle Eastern countries.

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The rise in inflationary pressures has stimulated a heated debate in many countries over the appropriateness of dollar exchange rate pegs, particularly in the Gulf countries. Given that Gulf governments find it politically difficult to trim fiscal expenditure at a time of booming oil revenues and that monetary policy is heavily constrained, it is difficult to see how inflation will be effectively tamed (in the absence of strong rebound in the dollar) without some upward adjustment in exchange rates. Although Moody's notes that a substantial portion of inflation is being generated by non-tradeable factors, particularly rents, which would limit the disinflationary impact of an exchange rate appreciation.

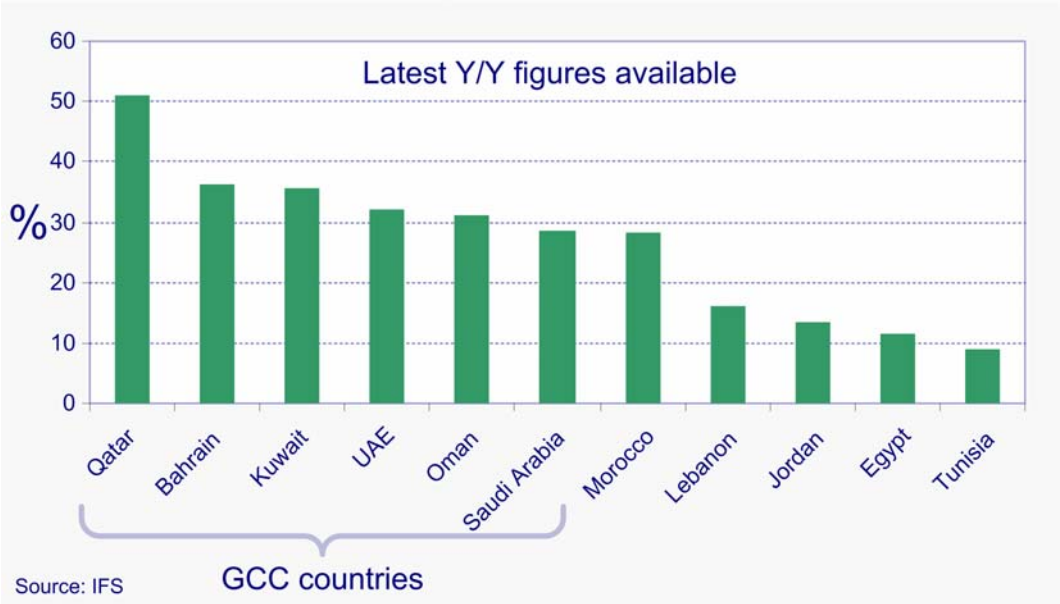
Negative real interest rates are encouraging asset price inflation

Although investors remain wary of some Gulf stock markets following their spectacular collapse in late 2005 and early 2006, most countries' equity markets are booming. Property prices have also risen significantly over the past several years throughout the region. This is partly a result of market fundamentals. Buoyant corporate profitability is boosting share prices while real estate demand is being stimulated by rising incomes, the opening of property markets to foreign investment, and rapid rates of immigration into some countries. Meanwhile, real estate supply is limited by an ageing housing stock, a shortage of land in some areas, and increasing competition for labour and raw materials. Yet negative real interest rates and rapid credit expansion have also played an important role.

Private sector credit growth is very strong in some countries

The rapid expansion of private sector credit, particularly consumer credit, is fueling inflation in some countries (see chart 5). Gulf oil exporters are experiencing the strongest rises in credit as banks, flush with liquidity, compete to expand their loan books. Some central banks in the region are gradually tightening restrictions on bank lending to consumers. Yet these efforts have not been stringent to date and credit continues to surge in many places. It is difficult to calculate the exact proportion of private credit growth that is being channeled into real estate and equities, although it is likely to be sizeable. Nascent mortgage markets are expanding rapidly in some countries. In Dubai, for example, some lenders are offering loan-to-value ratios as high as 97%. This raises concerns that a potential sharp correction in property prices in some Gulf states could hit banks' asset quality and raise governments' contingent liabilities.

Chart 5 – Private sector credit growth



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Infrastructure bottlenecks are not helping

The quality and quantity of infrastructure is struggling to keep pace with demand in many countries in the region, particularly in the real estate sector which is driving up rents. This is partly due to the region's historically low investment rates. Average investment rates in the Middle East have lagged the emerging market average for decades. As the public and private sectors have ramped up spending on construction, the competition for raw materials such as cement and steel has increased. This is especially pertinent for oil-exporting countries that are experiencing massive inflows of hydrocarbon receipts. Yet, non-oil exporting countries such as Egypt or Jordan are also affected by the oil boom as they receive private capital flows in the form of FDI and worker remittances from oil exporters, a portion of which is channeled into real estate.

Productivity could be damaged by inflation

Although the adverse effects of inflation have yet to hit the region's real GDP growth, which remains at historically high levels in most countries, we have begun to witness some negative aspects of inflation that could begin to affect activity. Most Gulf governments have imposed price controls on basic commodities and/or rent caps. We have seen several strikes taking place in Egypt and Lebanon, and even some sporadic protests by low-paid workers in some Gulf countries. Wage hikes in both the public and private sectors are being reported in most countries in the region with high inflation rates. The Egyptian government recently announced that it would hike the public sector basic wage by 30%. We have seen even larger public sector wage hikes in some Gulf states. These are triggering demands for salary raises in the private sector. In Lebanon, for example, unions recently demanded that the basic wage for private and public sector workers be tripled.

Governments face pressure to raise expenditure

Rising inflation is ratcheting up pressure on governments across the region to raise expenditure on salaries and subsidies in order to offset the erosion of citizens' purchasing power. Fiscal pressures are particularly acute in lower income countries such as Egypt, Jordan and Lebanon given that the poor are most exposed to inflation in basic goods and that their governments are already, for the most part, running sizeable deficits. Yet pressure is also building in the more affluent states, which are better able to afford expenditure increases.

As mentioned above, many governments in the region have announced large salary hikes for public sector workers. The federal government of the United Arab Emirates, for instance, announced a striking 70% rise in federal salaries in November 2007. Many other Gulf governments have since passed similar, albeit less dramatic, public sector wage increases. Most governments in the region are widening their subsidy nets. The cost of food subsidies in Egypt is expected to swell by a third in fiscal year 2008/09 compared with their level in 2007/08. In Jordan, current expenditures rose by 20% in 2007, partly driven by a higher wage and subsidy bill.

Maintaining fiscal discipline can have a political cost

Some governments in lower income countries are making bold efforts to limit the negative fiscal consequences of inflation. The government of Egypt recently announced a range of measures to boost revenues in order to offset its expanding salary and subsidy bill. These include increases in the domestic prices of fuel and cigarettes, and a curbing of tax exemptions for companies based in freezones. Jordan moved earlier this year to remove domestic fuel subsidies. The government of Lebanon has, at least on paper, planned a number of tax increases in order to improve its very poor public finances (although it remains to be seen whether these can be passed in the current political environment).

While Moody's generally assesses such efforts in a positive light given that they limit the adverse effects of expenditure increases on the government's repayment capacity, it also recognizes that such efforts can have a political cost. The imposition of tightening fiscal measures in an environment of rising prices can raise social tensions. An assessment of political or event risk is an important factor in Moody's ratings methodology.

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Lower income countries are more sensitive to inflationary risks

High and accelerating rates of inflation are more of an immediate rating concern in those countries in the region that have lower income levels and more constrained fiscal positions. This is because the risk of social pressures in countries with higher levels of poverty is greater and because fiscally constrained governments have less room to cushion the effects of inflation through higher public expenditure. We have therefore constructed two simple indicators in order to rank countries according to these criteria.

The first indicator measures social vulnerability and is made up of two sub-components: GDP per capita in purchasing power terms and the UN's Human Development Index (see table 1).

Table 1

Social Vulnerability Indicator

	PPP GDP per capita	Rank	UN HDI Score	Rank	Combined Rank
Morocco	4076	1	126	1	**1**
Egypt	5491	3	112	2	**2**
Jordan	4886	2	86	5	**3**
Tunisia	7473	4	91	3	**3**
Lebanon	11270	5	88	4	**4**
Saudi	23243	6	61	6	**5**
Oman	23967	7	58	7	**6**
Bahrain	32064	8	41	8	**7**
UAE	37293	9	39	9	**8**
Kuwait	39306	10	33	11	**9**
Qatar	80870	11	35	10	**9**

The second indicator measures fiscal flexibility and is made up of two sub-components: the latest annual fiscal balance and the level of net government debt/GDP (see table 2).

Table 2

Fiscal Flexibility Indicator*

	Fiscal balance	Rank	Net government debt/GDP	Rank	Combined Rank
Lebanon	-11	1	159	1	1
Egypt	-8	2	73	2	2
Jordan	-6	3	72	3	3
Morocco	0	5	54	4	4
Tunisia	-3	4	52	5	4
Bahrain	4	6	-30	6	5
Saudi	13	7	-60	7	6
Oman	14	8	-70	8	7
Qatar	15	9	-80	9	8
Kuwait	39	11	-200	10	9
UAE	31	10	>-200	11	9

**ranked in reverse order with higher ranked countries being less fiscally flexible*

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As a final step, we take the first two indicator rankings and combine them with the current rate of inflation to produce a rank ordering of country's "inflationary sensitivity" (see table3).

Table 3

Inflation Sensitivity Ranking

	Social Vulnerability	Fiscal Flexibility	Inflationary Pressure	Combined Score	Final Ranking
Egypt	2	2	1	5	1
Jordan	3	3	3	9	2
Lebanon	4	1	8	13	3
Morocco	1	4	11	16	4
Tunisia	3	4	9	16	4
Saudi	5	6	6	17	5
Oman	6	7	5	18	6
Qatar	9	8	2	19	7
UAE	8	9	4	21	8
Bahrain	7	5	10	22	9
Kuwait	9	9	7	25	10

The final ranking, as expected, shows that lower income, fiscally constrained non-oil exporters with high inflation rates are potentially more sensitive to the indirect adverse effects of inflation. High rates of inflation are of particular concern in Egypt (whose Baa3 local currency rating is on negative outlook) and Jordan given their social and fiscal vulnerabilities. Lebanon's very low B3 rating already encapsulates a high level of political and economic risk.

Although inflation may have longer-term rating consequences for richer oil-exporters

Although Gulf oil-exporters can currently afford to raise rates of government expenditure in order to cushion the social cost of inflation for its citizens, such actions are gradually making governments reliant on higher and higher oil prices in order to balance their budgets. This may constrain their ability to adjust to a potential future downturn in oil prices. Accelerating price growth is eroding economic competitiveness, particularly in non-hydrocarbon sectors, while the rising cost of living is making Gulf countries less attractive destinations for expatriate workers. This could potentially undermine governments' efforts to develop their non-oil sectors and thereby diversify away from oil. Finally, as stated above, the unorthodox economic measures that Gulf governments are imposing in an effort to contain inflation, such as price controls, could affect real activity by distorting economic incentives.

For a fuller discussion of inflation in the Gulf, please see our special comment published in January entitled "GCC: Inflation-fueled government expenditure hikes could have future rating implications".

Moody's Related Research

Statistical Handbook:

- Moody's Country Credit Statistical Handbook, May 2008 (109112)

Rating Methodologies:

- Sources and Uses of Statistical Data in Moody's Sovereign Credit Analysis, December 2006 (101207)

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- The Local Currency Deposit Ceiling, August 2006 (98554)
- Revised Foreign-Currency Ceilings to Better Reflect Reduced Risk of a Payments Moratorium in Wake of Government Default, May 2006 (97555)
- Sovereign Rating Methodology Handbook, February 2004 (78529)

Special Comments:

- Sovereign Default and Recovery Rates, 1983-2007, March 2008 (107687)
- Inside Moody's: Focus On The Middle East, March 2008 (107967)
- Bank Ratings and Government Bond Ratings, August 2007 (103903)
- Analyzing the Tradeoff between Ratings Accuracy and Stability, September 2006 (99100)
- A Guide to Moody's Sovereign Ratings, August 2006 (98177)
- A Quantitative Model for Foreign Currency Government Bond Ratings, February 2004 (81176)
- A Quantitative Model for Local Currency Government Bond Ratings, September 2003 (79404)

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