# The Second Round of the Energy Subsidy Cut

July 02, 2017

As expected, the government carried out the second round of the energy subsidy reform program. Fuel prices rose by an average of 50%, while the electricity tariff increase will take effect on July's consumption. This is part of the government's effort to narrow a high unsustainable budget deficit, which will help cure the macroeconomic imbalances in Egypt. The timing of the decision was anticipated ahead of the traditional high consumption season in the summer.

## We revised our overall fiscal deficit forecast lower from 10.1% of GDP to 9.8% of GDP in FY2017/18

Under the new prices, we expect the total energy subsidy to be in line with the government budgeted amount of EGP140 billion. Meanwhile, we estimate the total expenditure to decline from EGP1262.7 billion to EGP1253.9 billion in FY2017/18. We note that our budget projection factors in an increase in the total spending that reflects a higher than expected inflation rate/exchange rate in FY2017/18 (Please revisit our note on FY2017/18 budget: Bridging the Fiscal Gap). **Accordingly, we expect the fiscal deficit to narrow from 10.8% in FY2016/17 to 9.8% of GDP in FY2017/18. Most importantly, we project the primary budget deficit to decline from 1.3% of GDP in FY2016/17 to 0.1% of GDP in FY2017/18.** While these figures remain above the government targets of an overall budget deficit equivalent to 9% of GDP and a primary surplus around 0.3% of GDP in FY2017/18, yet it confirms the government's commitment to reform.

## The Inflationary shock to last for 3 months before the annual inflation rate starts decelerating as the general price level stabilizes, in addition to a favorable base effect

We estimate the annual inflation to reach an average of c.33% in 1Q FY2017/18 as the economy fully absorbs the new energy products price, in addition to the value added tax 1% increase. Empirical evidence from the previous rounds of fuel and electricity price hike support our conclusion (Chart). Following the energy products price increase in July 2014, the monthly core inflation rate accelerated to 1.8% before decelerating to 0.5% in October 2014. Applying similar measures, in addition to the exchange rate liberalization in November 2016, the monthly core inflation rate accelerated to 5.3% before decelerating to 1.0% in March 2017.

## The MoF and CBE preemptive measures were meant to minimize the impact on the most vulnerable and to contain the inflation second round effects

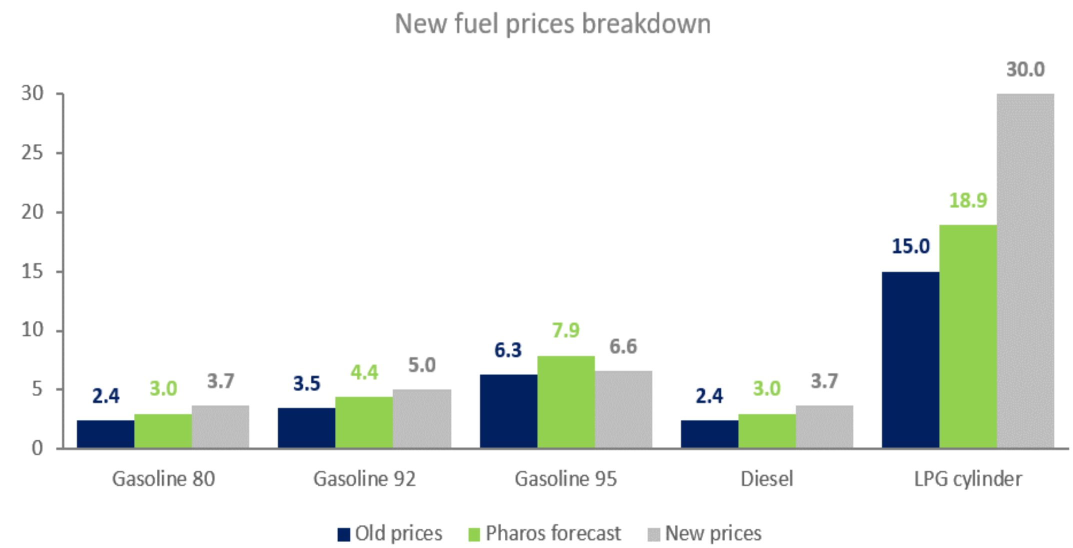
Ahead of the fuel price and electricity tariff hikes, both the Ministry of Finance and the CBE undertook two preemptive measures:

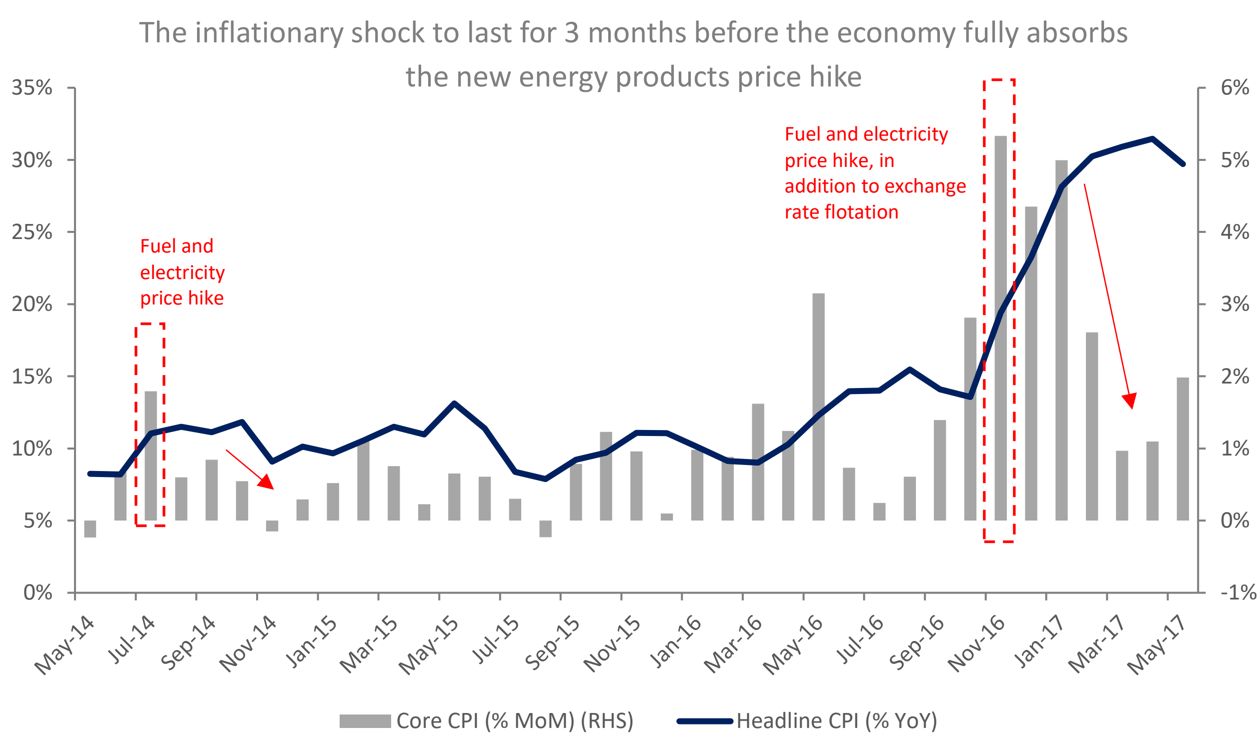
- Recently, the Ministry of Finance announced a new social spending package, which included an income tax credit/exemption to the lower income group, higher per capita commodity subsidies and extra funds to Takaful & Karama. This package was designed to help the most vulnerable weather the aforementioned inflationary pressure.
- While we reiterate that the first round effect of the energy subsidy cut is inevitable and transitory, the CBE's recent 200bps interest rate hike will also help absorb the demand-pull second round effects.

## We expect the CBE to keep policy rates unchanged in the next MPC meeting, with a possibility of an another short-term rate hike in case of a larger than expected inflationary shock

We expect the CBE's Monetary Policy Committee to keep interest rates unchanged in the coming meeting on July 6. This is supported by our Financial Conditions Index reading, which shows that the recent 200bps policy rate hike is still feeding into the system, in addition to a deceleration in the latest annual inflation rate. However, we reiterate that we should not rule out the possibility of another interest rate hike over the short term in case the inflationary shock proves to alter the annual inflation rate from the CBE's target (13% by 4Q 2018 +/- 3%).

**Finally, we expect the IMF executive board to approve the disbursement of the second tranche shortly. While social and political risks remain a concern, we note that the policy communication needs further improvement in order to minimize such risks. Furthermore, we believe that undertaking the second round of the energy subsidy cut will help attract more FDI & PDI as it reaffirms that the government is serious about economic reform.**




Source: Central Bank of Egypt, Pharos research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