Egypt MPC Watch| Environment Supports Cut; Not Necessarily Imminent or Significant

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Inflation decelerating faster than expectations

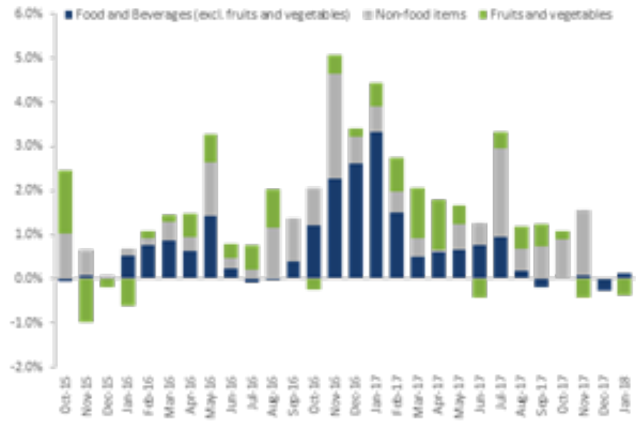
The monthly inflation rate decreased by 0.2% in January 2018 resulting in a significant annual deceleration, by 520 bps from 22.3% in December 2017 to 17.1% in January 2018, which is the lowest level of annual inflation witnessed since the flotation of the Pound in November 2016. The significant annual drop was due to the base effect, and the monthly deflation was mainly attributed to the drop in vegetables prices by 3.3% MoM.

CBE is right on target for inflation deceleration

Going forward, we expect the annual inflation rate to decelerate from 27% in 2Q FY2017/18 to 15.3% YoY in 3Q FY2017/18, and 12.6% YoY in 4Q FY2017/18. According to our estimates, the deceleration of inflation level should happen, despite the upcoming fiscal consolidation measures, which are:

- The planned increase in transportation prices in July 2018, specifically metro ticket prices by c.100% and train ticket prices that may be raised by 15-150% depending on type of train and the distance traveled.
- The planned increase in electricity prices in July 2018 by 2-10% for residential use, and up to 20% for industrial and commercial users.
- The energy subsidy cut planned for 1Q FY2018/19, which will be after presidential elections, and early on, before the start of the new fiscal

Chart 1: Contribution to the monthly inflation



Source: Pharos Research, CAPMAS

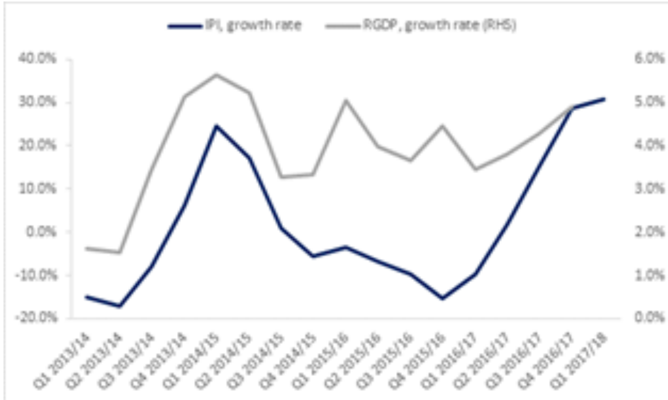
Chart 2: Annual and Monthly Inflation in Egypt

Source: Pharos Research, CAPMAS

RGDP growth projections do not create pressure to cut rates imminently

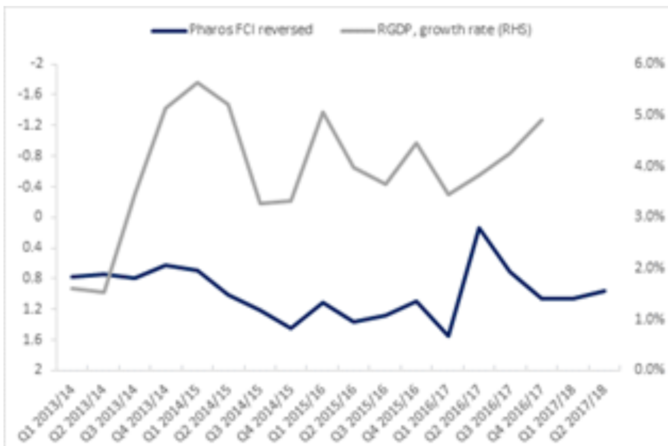
The RGDP growth rate has recorded a healthy 4.9% in 4Q2016/17, and the government expects further improvement in 1H2017/18. Although official figures have not been released yet, the Industrial Production Index and Pharos Financial Conditions Index, which reflect RDGP growth depict positive growth numbers over 1H2017/2018 indeed. Such healthy momentum in RGDP growth creates no pressure to cut rates imminently.

Chart 3: IPI and RGDP growth rate tend to move in tandem



Source: Pharos Research, CBE, Ministry of Planning

Chart 4: Pharos FCI is a mirror indicator for RGDP growth rate



Source: Pharos Research, CBE

Pharos Financial Conditions Index depicts less tight monetary conditions, despite high rates

The broad money supply (M2) increased in December 2017 by 20.9% YoY. Moreover, the real broad money supply increased also by 4.6% YoY. The increase in real M2 reflects less tight monetary conditions, despite the high interest rate environment. Thus, cutting policy rates in the coming MPC meeting would fuel an even higher money supply growth and hinder inflation deceleration, at least in the short-term. In order not to fuel higher growth in money supply and to properly manage consumer expectations, we might see the MPC maintain rates in the upcoming meeting.

Government finance cost eased by drop in treasury yields and the shift towards external debt

The average yield for 3-month TB issued in January 2018 fell to 18.64%. The reduction in ST yields, since July 2017, reduces the impact of the high interest rate environment on the government. This in turn supports maintaining rates on the short-term. The shift in government focus on more external rather than local debt supports debt service payments as well, even if rates were to remain high for another six months.

Chart 5: The decrease in ST treasury yields minimizes pressure on debt service

Source: Pharos Research, CBE

IMF encourages prudent monetary policy and inflation targeting as ST priority

In its recent report on Egypt, the IMF praised the CBE for maintaining a prudent monetary policy stance and urged a gradual easing of policy interest rates only once the authorities are confident that demand pressures and inflation expectations remain contained. Thus, inflation targeting will be a top priority for CBE in the short term, while the medium term objective will be raising inclusive growth and increasing employment.

The status of three potential risks to determine the timing of policy rate cut

We believe that inflation declaration will continue, leading the annual inflation rate downwards to 12.3% YoY in 2Q FY2018/19 (4Q 2018), which is in line with the CBE inflation target of 13% YoY (± 3%) by 4Q 2018.

This supports the MPC ease the current tight monetary stance, however, the timing remains conditional upon the materialization of three potential risks to the aforementioned inflation outlook:

- The recent international oil price rally could lead to an earlier/larger than expected domestic subsidy reform measures.
- A higher real absorption or domestic demand growth, as a result of the recent pickup in the economic activity.
- The projected pace of the monetary policy normalization in advanced economies.

Accordingly, the inflation deceleration pace and the higher chances of hitting the CBE's inflation target by June 2018, raise the chances of a rate cut in the upcoming MPC meeting. However, due to the fiscal consolidation measures stated above, the "prudent management of the rational expectations of consumers", and monetary policy in advanced economies, we believe that there are high chances of maintaining rates in the upcoming meeting, or if we witness a cut, it will be limited to c.1.0%-2.0%.

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