Fundamentals

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Macroeconomic update | Strategy | Monetary policy analysis | Egypt

Temporary pause, not halt

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IN BRIEF

- Central Bank of Egypt left the policy rates unchanged in its June MPC meeting.
- First-round effect of the upcoming quarterly fuel price adjustment, second round effect of the FX devaluation pass-through effect and global rate tightening cycle should see inflation peak in the third quarter.
- As such, we expect further hikes (a combined 250bp) in the two MPC meetings in the third quarter to take back the real policy rate into positive territory at the tail end of the year. This should attract offshore portfolio inflows amidst external sector imbalances.
- External buffers are fragile with a dip of USD 5.5bn in FX reserves YTD, coupled with a negative net foreign assets position in the banking system implies further weakening pressure on the Egyptian Pound in the near-term.
- The impending rolling over of Gulf Cooperation Council (GCC) countries' deposits into investments as the state divestitures control of state-owned enterprises should offer the local currency stability in the medium-term. An IMF program, as and when ironed out, should unlock further financing flows in FY2022/2023, and ease investor anxiety.
- The previous rate hikes are yet to filter through the market, tempered by the low acceptance at the primary auctions. We think further tightening stance should dial upwards local rates and attract offshore flows.

Inflation to peak in the third quarter

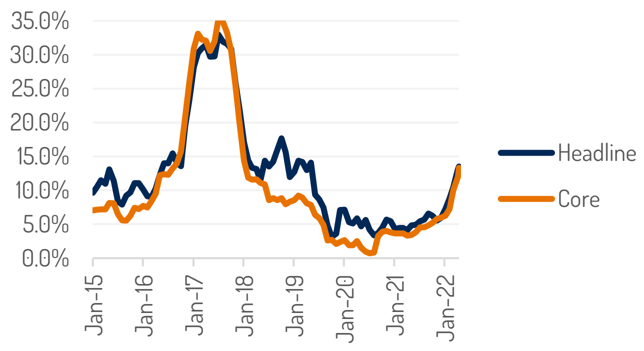
While headline inflation moderated in the latest print (May 2022), we think the peak is yet to be hit. The next round of fuel price review by the Automatic Pricing Committee for Pricing Products is slated for July. We expect further upward adjustment, on the back of decade-high global oil prices.

This should feed into first-round inflationary pressure, whereas the FX devaluation pass-through should see core inflation elevated. We see inflation peaking in the third quarter (13.5%: May 2022) although the path is highly uncertain. Against this backdrop, we see further tightening (c. 250bp) by the CBE in the second half of the year.

It could be argued that the modest uptick in the latest inflation numbers gave policymakers scope to sit on the sidelines. Headline and core inflation inched up 1.1% and 1.6% m/m respectively, the slowest m/m uptick in three months. Fruits and vegetables retreated the most by 10.1% m/m, fading off the seasonal Ramadhan effect that was salient in the month of April. This had the effect of the overall moderation in food inflation (0.6% m/m). However, the regulated items (with a weighting totalling 21.4%) climbed the most, reflecting the upward price adjustments on select commodities.

A cumulative 250bp hike (current main operation rate: 11.8%) in the coming quarter should take real policy rate into positive territory by the end of the year, to attract the much-needed portfolio flows. The third quarter inflation peak is also cemented by expectation of moderation in food inflation. Wheat price is down 14.7% month-to-date giving some reprieve to Egyptian consumers. On the supply side, the Egyptian authorities have secured wheat stocks running until mid-December, from the current stock reserves coupled with the upcoming season's harvest. That said, inflationary path remains largely uncertain more so with the aggressive tightening by developed markets' central banks. The US Federal Reserve has pencilled in further 200bp lift-off in the benchmark rate; this cough portends a cold to emerging economies such as Egypt

Evolution of CPI inflation

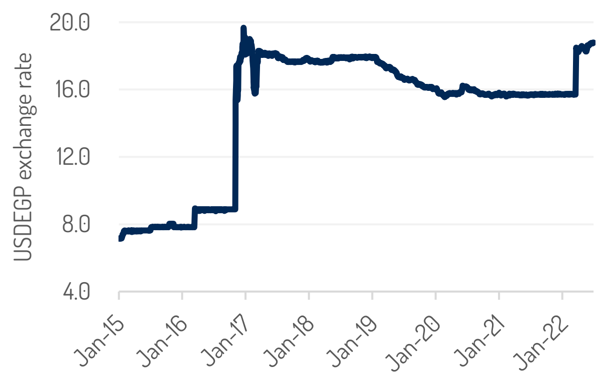


Source: Central Bank of Egypt (CBE), Central Agency for Public Mobilization and Statistics (CAPMAS)

Sting not yet removed from EGP

Policymakers acknowledged the impact of FX devaluation pass-through in the MPC press statement. In our opinion, the local currency is not yet out of the woods, but upcoming external financing should ease near-term FX pressure. The Egyptian Pound has had a gradual adjustment post its 21 March devaluation event, depreciating a further 3.0%. This is pretty remarkable, against a USD 5.5bn (-13.4%) decline in its FX reserves to USD 35.5bn (May 2022) from peak February levels. The FX position looks fragile, with a negative net foreign assets (NFA) of USD 12.7bn in the banking system (both, CBE and banks), levels last seen in October 2016. The significant decline in net foreign assets implies some further depreciation of the Egyptian Pound, though authorities' have been less tolerant of violent swings in the local currency.

Evolution of the Egyptian Pound (spot rate)

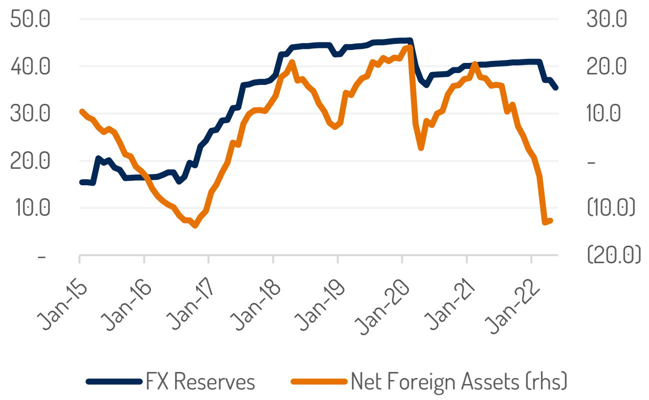


Source: Bloomberg

The CBE's negative NFA position (USD 6.2bn: May 2022) is expected to improve once the Gulf Cooperation Council (GCC) commitments are disbursed. To be sure, initial deposits from Qatar (USD 3bn), Saudi Arabia (USD 5bn), and United Arab Emirates (USD 3bn) totalling USD 11bn mainly contributed to the jump in the apex bank's foreign liabilities in 1Q2022, and ultimately, the dip in NFA position. But we expect the GCC countries to roll over the deposits into tangible investments in the near-term, which will shore the CBE's NFA position back into positive territory.

Egypt has doled out an ambitious privatization plan, expected to be implemented over a 3-year cycle, which we believe will benefit from the GCC investment. The GCC financing has helped stem the local currency's sharp deterioration post the devaluation, amidst portfolio outflows that was marked at the front end of the Russia-Ukraine war. This, has also given Egypt some wiggle room as it negotiates for a new IMF program which is expected to be ironed out in 2H2022.

External buffers (USD bn)

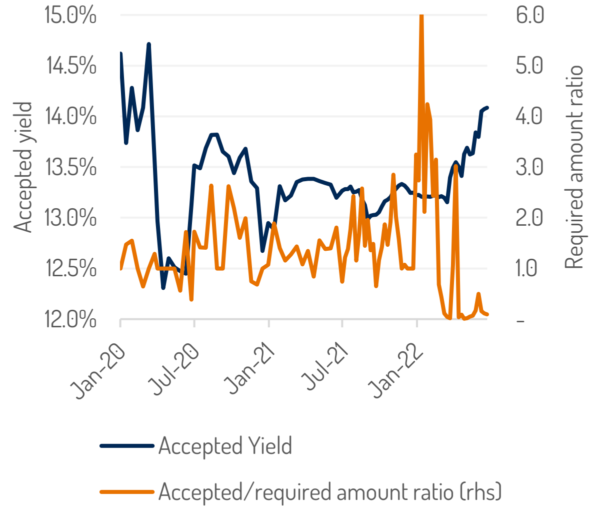


Source: CBE

Conclusion: The carry trade – A waiting game

Although Egypt has delivered a cumulative 300bp in rate hike over this tightening cycle, local rates have remained broadly stable. The 1-year T-Bill yield has increased by 90bp since mid-March, supported by the low acceptance rate at the primary auction. Although inflationary path is highly uncertain, an aggressive monetary policy tightening should wade off second-round effects. We believe the carry trade should be attractive once the IMF programme has been ironed out, expected in the latter half of this year. Furthermore, the ongoing structural adjustment – ambitious privatisation plan – should bring long-term cheer to investors.

364-day T-Bill



Source: CBE

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