FUNDAMENTALS

EGYPT: FX ADDS UPSIDE TILT TO POLICY OUTLOOK

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IN BRIEF

- The Central Bank of Egypt (CBE) unexpectedly left the benchmark deposit rate unchanged at 16.25% during its Monetary Policy Committee (MPC) meeting held last Thursday.
- Base effects should see the inflation rate (Dec 2022: 21.3%) trend lower from 2Q2023, but a linear path for inflation normalization may not be clear-cut with FX pass-through yet to fully filter through
- With an explicit inflation target of 7.0% (±2.0%) on average by 4Q2024, the CBE telegraphed policy pause for longer as the frontloaded rate hikes transmit through the market.
- Nevertheless, there are two issues driving FX expectations. The first one is 'If" the CBE will stick to its course this time round.
- Secondly, the idea of a flexible exchange rate is not necessarily two-directional but asymmetric, with some downside bias for the Egyptian pound.
- Thus, with FX pass-through still filtering through, we see scope for rate tightening (cumulative +200bps) in upcoming MPC meetings in 2023.
- With real rates expected to remain in the negative territory, we remain less constructive on the local rates (364-day T-Bills)

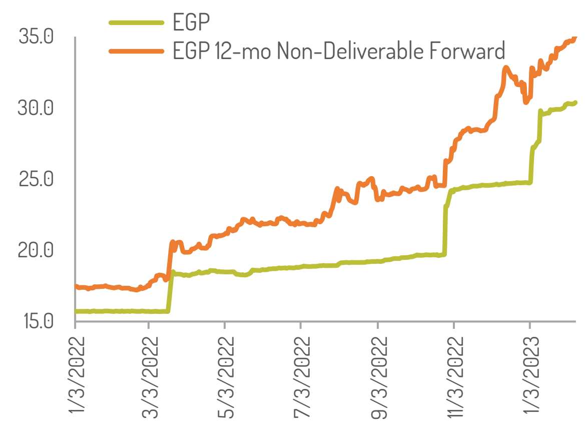
Unexpected pause in rate hikes amidst rising inflation

The Central Bank of Egypt (CBE) unexpectedly left the benchmark deposit rate unchanged at 16.25% during its Monetary Policy Committee meeting held last Thursday. This pause came against a cumulative 800bps rate hikes frontloaded over the course of last year. The CBE also left unchanged the overnight lending rate and the rate of main operation at 17.25% and 16.75%, respectively. In line with the IMF programme, the daily overnight rate has been within 50bps of the mid-corridor rate (16.75%) since the October 2022 MPC meeting.

The neutral policy stance notwithstanding, inflation remains perched, driven by food inflation. Although favourable base effects are expected to kick in from 2Q2023, the path for inflation normalization will be bumpy as the FX pass-through is yet to filter through. Headline inflation is currently at a 5-year high (Dec 2022: 21.3% y/y), with food inflation (28.0% y/y) more pronounced. Core inflation, at 24.4% y/y, pencils in the second-round effect of the supply shocks on international commodity prices and the FX pass-through. The gradual implementation of the fuel price indexation, as part of the IMF programme, will give inflation some legs.

Although the CBE emphasized "the path of future policy rates remains a function of forecasted inflation rather than prevailing inflation rates…", we opine that the path is less clear-cut, amplified with a dearth in inflation projections from the apex bank. Furthermore, news flow coming out of Egypt suggests that the FX crunch to the real sector is yet to fully thaw, implying further FX pass-through to inflation in the near-term. We thus see scope for rate tightening (+200bps) in upcoming MPC meetings this year. However, playing the devil's advocate, the explicit inflation target of 7.0% (±2.0%) on average by 2Q2024 gives the CBE ample time to sit on the side-lines as the frontloaded rate hikes transmit through the economy.

EVOLUTION OF THE EGYPTIAN POUND



SOURCE: BLOOMBERG

History keeps us cautious on the shift to flexible FX regime

But back to the present. The overriding question is whether the nascent shift to a flexible exchange rate will be the norm rather than the exception. The institutional memory of the market is that we have been here before: an Egyptian pound devaluation. To be precise, November 2016. But that particular episode was marked by a policy reversal which led to FX imbalances which necessitated four step devaluations since March 2022. As such, there are two things that has built up in FX expectations. The first one is undoubtedly the "If" question. The old adage goes, once bitten twice shy. Thus, the market keeps looking for clues of "If" the CBE changes course.

This leads to the second issue, flexibility of the exchange rate. We do not believe that the market is necessarily eyeing a two-directional flexibility of the exchange rate, but an asymmetric one with a downside bias on the Egyptian pound. Although the Egyptian Pound is down 18.3% YTD following the two devaluation events last month, the current official rate is 15.0% overvalued as per the market's expectations (proxied by 12-month forward rate on the currency). The government has baked a shift towards durable FX stability with emphasis towards Foreign Direct Investment (FDI). However, we see implementation risks to the intended USD 2.5bn State-Owned Enterprises (SOEs) divestiture program by end-FY23. However, there have been some bright spots. Media reports indicate that at least USD 9.2bn of backlog import goods were cleared last month from Egyptian ports following the repeal of Letter No. 49 of 13th February 2022 – letters of credit were made a prerequisite for bank import financing - at the tail end of last year. Net international reserves are up USD 1.1bn to USD 34.2bn in Jan-2023 from July 2022 levels. Net foreign assets in banks have improved from negative USD 16.5bn in Oct-2022 to negative USD 11.7bn in Dec-2022, suggesting a convergence between the official exchange rate and the parallel exchange rate may occur in the near-term.

We remain less constructive on local rates

With real rates (364-day T-Bills minus trailing inflation) expected to remain in negatives throughout 1Q2023 (Dec 2022: -240bps), we don't see scope for offshore portfolio inflows. Locally, two state banks – Banque Misr and National Bank of Egypt – mopped USD 21.1bn on 1-year 25.0% certificates of deposits to partly stymie the devaluation effect. Offshore holdings in 364-day T-bills stood at USD 6.5bn (7.4% share of total 364-day T-bills) and the MPC signalling a halt for longer has reduced a carry play in the local market.

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