FUNDAMENTALS

EGYPT MPC UPDATE: LONG AND VARIABLE LAGS ALLOW POLICY PAUSE

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IN BRIEF

- As widely expected, the Central Bank of Egypt (CBE) maintained its benchmark overnight deposit rate at 18.25% in its May 2023 Monetary Policy Committee (MPC) meeting held last week.

- Base effects led to a softening in April 2023 inflation to 30.6% (March 2023: 32.7%). Core inflation also decelerated to 38.6% from 39.5% in March 2023; elevated food inflation more than offset by the downward sticky retail and services items.

- Price pressure on notable commodities has eased off materially. Wheat price (-23.6% YTD) and ample wheat reserves (4.9months) implies positive knock-on to food items, and ultimately core inflation. Slower growth also suggests some weak inflationary demand in the economy.

- Nonetheless, the unresolved FX availability to the real sector risks unleashing upside inflationary pressure, in our view. Gleaning the latest balance of payments report (4Q2022) leaves us with the sense that the current account surplus (USD 1.4bn) was on the back of FX restrictions, rather than organic forces

- Although the on-the-run risk-on sentiment by offshore investors is laudable, sudden portfolio outflows could further destabilize the EGP in a material risk-off environment. In our view, this risk is amplified by the slow pace of IMF programme reforms, specifically targeting the sale of State-Owned Entities.

- Furthermore, the three main credit rating agencies have recently announced adverse credit actions on Egypt which may further spook investors and exacerbate portfolio outflows.

A pause to allow 'Long and variable lags' effect

As widely expected, the Central Bank of Egypt (CBE) maintained its benchmark overnight deposit rate at 18.25% in its May 2023 Monetary Policy Committee (MPC) meeting held last week. With April 2023 inflation trending lower, this gave the policymakers some breathing policy space. Concerns around FX availability to the real sector together with slower implementation of the IMF programme means Egypt inflation outlook is not yet out of the woods. Nevertheless, the policymakers made it clear that it is assessing the impact of the cumulative 1,000bps hike this cycle, and the 400bps increase of its required reserve ratio. For an inflation-targeting central bank, the policy statement maintained that "*the path of future policy rates remains a function of forecasted inflation rather than prevailing inflation rates*" which, in our view, is a subtle suasion by the policymakers to the market to 'ignore' the current elevated inflation

Softer April inflation on base effect

Base effects led to a softening in the April 2023 inflation to 30.6% (March 2023: 32.7%). Core inflation also decelerated to 38.6% from 39.5% in March 2023; elevated food inflation more than offset by the downward sticky retail and services items. On a monthly basis, the growth in both headline and core slowed to 1.7%, reflective of a broader slowdown in the month-on-month price increases. Inflation for regulated items edged higher to 12.5% (March: 11.3%) following the price hike implemented by the Eastern Tobacco Company in late March. Amidst an inflationary environment, the government announced a new social package totaling EGP 40bn and EGP 150bn to be implemented in FY23 and FY24, respectively.

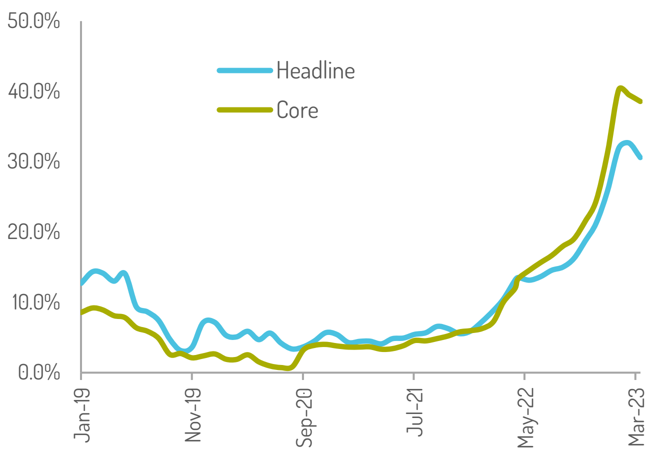
Steady inflation outlook but with scope for upside surprise

Against consensus expectation of Ramadhan cyclical upside bias, April 2023 inflation came in lower-than-expected. This tees up the odds of continued softer print in the near-term horizon on base effects. Additionally, price pressure on notable commodities has eased off materially. Wheat price (-23.6% YTD) and ample wheat reserves (4.9months) implies positive knock-on to food items, and ultimately core inflation. Slower growth also suggests some weak inflationary demand in the economy. Electricity tariff hike, postponed to June 2023, with the quarterly fuel price adjustment may offset the base effect and pose upside inflation surprise.

Calm before the storm for EGP?

The unresolved FX availability to the real sector risks unleashing additional upside inflationary pressure, in our view. Gleaning the latest balance of payments report (4Q2022) leaves us with the sense that the current account surplus (USD 1.4bn) was on account of FX restrictions, rather than organic forces. The underbelly of the Egyptian Pound "EGP" (-19.9% YTD) is exposed with a deteriorating net foreign liability position of USD 24.5bn as of March 2023; an increase of USD 4.5bn YTD in net foreign liabilities. Whereas CBE's net foreign liability increased by USD 644.9mn, the commercial banks' position weakened by USD 3.8bn, amplifying risk of a protracted clearance of FX backlogs. Bright spots for FX have been the steady rise of the net international reserves to an 11-month high of USD 34.6bn (April 2023), while the attractive carry play amidst a rising rate environment has seen offshore holdings of outstanding T-Bills at 18.6% (February 2023).

INFLATION



SOURCE: CAPMAS, CBE

Negative signaling by Rating Agencies amidst delayed IMF review

Although on-the-run risk-on sentiment by offshore investors is laudable, sudden portfolio outflows could further destabilize the EGP in a material risk-off environment. In our view, this risk is amplified by the slow pace of IMF programme reforms, specifically targeting the sale of State-Owned Entities. The first review for the IMF programme, scheduled for mid-March 2023, has been delayed although the authorities have downplayed the delay. Having secured external financing for the current FY23, the authorities have shown some complacency with the expected c. USD 348.8mn (assuming current SDRUSD rate) disbursement after the first review now scheduled at the front end of FY24. Furthermore, the three main credit rating agencies have recently announced adverse credit actions on Egypt, which may further spook investors and exacerbate portfolio outflows. Fitch Ratings downgraded Egypt from B+ to B, with a negative outlook. Whereas S&P Global Ratings (B rating) signaled a downgrade in the next 2 years with a 'negative outlook', Moody's 'negative review' implies a further downgrade from its current B3 rating within the next three months.

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