Pharos

When Will the CBE Start Monetary Easing?

An Earlier Than Previously Expected Scenario

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In a previous macroeconomic research note, we explained that the framework of the economic reform program in Egypt aims at tapering the high aggregate spending level that is inconsistent with the fundamentals of the economy. As the production capacity (aggregate supply) is fixed in the short term, rebalancing the Egyptian economy implies a slower domestic demand growth that would narrow the negative resource gap. Accordingly, this would revamp the economic growth dynamics, ease the pressure on the exchange rate, in addition to bringing down the high inflation rate (please, see our research note: The Challenge of Bringing Down High Absorption).

Leading indicators suggest that the absorption growth rate is decelerating significantly in 1Q2017/18

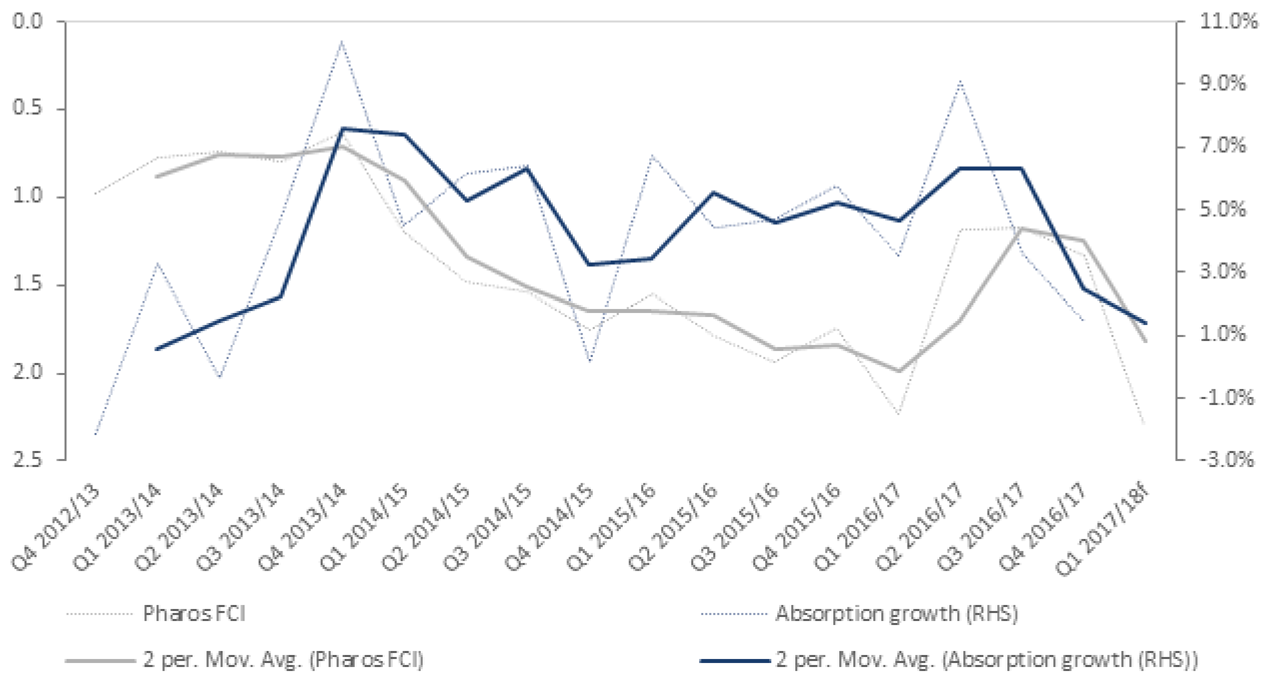
Prior to November 2016, the absorption growth rate rose significantly from an average of 4.5% in 2015/16 to 6.3% in 1H 2016/17. This could be explained by policy uncertainty as the economic pressure intensified and/or in anticipation of a severe economic reform measures. Following the exchange rate liberalization and the first round of the energy subsidy cuts in 2Q2016/17, the absorption growth rate eased to 3.6% in 3Q2016/17. However, this was not enough to ease the inflationary pressure. Despite decelerating, the average monthly inflation rate recorded 2.9% in 3Q2016/17, versus an average of 1.1% in 2015/16. This is largely explained by the absorption level (demand forces) as the Egyptian economic agents traditionally tend to spend more (i.e. pile up more inventories, durable goods and gold) in order to hedge high inflation expectations. Therefore, the CBE initiated two consecutive rounds of interest rate hikes, in addition to another round of the energy subsidy cuts by the Ministry of Finance. In reaction, we estimate the real absorption growth rate to drop significantly in 1Q2017/18. Our Financial Conditions Index (FCI), which is a proxy measure of the domestic demand growth, forecasts a significant slowdown in tandem with the recently applied tight monetary and fiscal policy measures.

Our baseline scenario suggests that the Inflation rate already peaked following the recent fiscal reform measures in July

The annual headline inflation rate recorded 33.0% in July, in reaction to the second round of the energy subsidy cut and the VAT rate increase from 13% to 14%. We estimate the monthly inflation pace to ease in the coming months, steering the annual inflation rate downwards going forward. This is supported by the waning supply shock, in addition to the aforementioned domestic demand deceleration.

The CBE to start easing the monetary stance earlier than previously expected

While we previously expected the CBE to start monetary easing by the end of 2017, the aforementioned analysis suggests that we shall not rule out an earlier move. In our view, a quicker than previously expected policy loosening is consistent with balancing the risks to both the economic growth and the inflation outlook. However, the current proactive CBE implies that the stance of the monetary policy follows a data-driven approach. Hence, the magnitude of the monthly inflation pace in August is key to either confirm/deny our conclusion. While a supportive monthly disinflation pace would support a rate cut, the opposite case could initiate further tightening (The latter is not our baseline scenario).



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