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Egypt MPC Watch

Expect MPC to Hold Rates Unchanged, with a Possibility of 50bps Rate Cut

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Inflation rate to decelerate to 27.1% YoY in 2Q FY2017/18

As expected, the monthly headline inflation rate nearly halved from 3.2% MoM in July to 1.1% MoM in August, leading the annual headline inflation rate to decelerate to 31.9% YoY in August. We note that the core monthly inflation rate, which indicates the underlying inflationary pressures, decelerated sharply from 2.8% MoM in July to 0.3% MoM in August. This supports our previous view that the negative impact of two consecutive supply shocks has already faded away. Accordingly, we expect the average annual headline inflation rate to decelerate from c.33% YoY in 1Q FY2017/18 to 27.1% YoY in 2Q FY2017/18. In our view, the fact that there are no major fiscal readjustments on the horizon, in addition to the CBE's recently published inflation forecast will both help keep inflation expectations in check. Hence, our baseline inflation rate forecast indicates that the CBE's annual inflation rate target of 13% YoY (± 3%) is achievable by 2Q FY2018/19.

The real absorption growth deceleration reduces demand-side pressures amid changing growth dynamics

In a previous macroeconomic research paper, we explained that leading indicators are showing a decline in the real absorption growth rate (demand forces) from 9.1% YoY in 2Q FY2016/17 to 3.6% YoY in 3Q FY2016/17 and 2.6% YoY in 4Q FY2016/17 (see our Macroeconomic research note: *When Will the CBE Start Monetary Easing?*). A lower real absorption contribution to the real GDP growth was offset by a positive contribution from the trade balance as the deficit declined from USD9.3 billion in 2Q FY2016/17 to USD8.1 billion in 3Q FY2016/17 and USD7.3 billion in 4Q FY2016/17. Hence, economic growth remained robust, recording 4.3% YoY in 3Q FY2016/17 and 4.9% YoY in 4Q FY2016/17.

Fixed income market dynamics suggest a gradual monetary easing; The interbank spread remains negative since August

We highlight three key developments in the financial markets over the last month:

- The T-bills demand coverage ratio continued to rise from 1.8 times in August to 2.3 times as of September 18, steering yields downward from an average of 19.5% in August to 19.0% as of September 18. We note that the Ministry of Finance (MoF) kept the supply ratio unchanged at 1.2 times, similar to August. **Refraining from taking advantage of such a yield decline may signal an anticipation of an interest rate cut over the short-run by the MoF. On the other hand, fixed income investors' growing appetite to lock-in return despite a yield drop also supports an interest rate cut expectation.**
- The T-bonds demand coverage ratio declined from 3.6 times in August to 2.2 times as of September 18. Meanwhile, the MoF supply ratio rose from 1.0 times in August to 1.7 times as of September 18. Hence, the yields dropped from an average of 16.9% in August to 16.1% as of September 18. **Such an increase in the long-term debt supply appetite may reflect the MoF projection of a gradual monetary easing scenario. Moreover, lower demand on such yield level also opposes an aggressive interest rate cut scenario.**
- The average daily overnight interbank rate recorded 19.0% as of September 18, below the mid-corridor rate (19.25%) for the second consecutive month, which reflects improved liquidity (less tight monetary stance).

A USD11.5 billion off-reserve account balance supports the CBE's monetary policy autonomy, limiting the impact of the expected monetary easing on the nominal exchange rate

Ahead of an anticipated monetary easing cycle, we believe that the impact of cutting the nominal interest rate on the EGP exchange rate will be limited despite the significant increase in the foreign inflows in the local debt market.

- In an extreme case of full/instant foreign fixed income portfolio outflows, c.70% of the total foreign holdings of EGP-denominated treasuries are well covered by the CBE's off-reserve account. In other words, such an amount could be paid without affecting the CBE's foreign reserves and the banking sector FX liquidity. This is due to the CBE's USD11.5 billion held in an off-reserve account balance by the end of August. The remaining amount (USD4.5 billion as of the end of August) would be disbursed entirely/partly from the reserves, leading to a limited exchange rate short-term volatility.
- A gradual monetary easing in tandem with further BoP fundamentals improvement would also help offset the impact of slower foreign purchase of EGP-denominated treasuries. We note that the FDI coverage of the current account deficit, excluding grants, continued to improve from USD -4.3 billion in 4Q FY2015/16 (USD -1.3 billion in 3Q FY2016/17) to USD -1.1 billion in 4Q FY2016/17.

MPC to hold policy rate unchanged, with a possibility of 50 basis points interest rate cut

On a forward-looking reaction function, we see a possibility of an interest rate cut by 50 basis points in the next MPC meeting on September 30. This is mainly supported by the favorable aforementioned inflation outlook, in addition to waning demand-side pressure risks. On the other hand, we believe that the real absorption growth rate has gained some strength in 1Q FY2017/18. This is in line with the recently announced real GDP growth rate figure of 4.8% – 5.0% in 1Q FY2017/18. Accordingly, we remain tentative whether the real absorption growth pace would be enough to convince the MPC to start monetary easing earlier than originally anticipated. Hence, holding the nominal interest rate unchanged in the next MPC meeting remains in play.

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