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Profit Margin Control Initiative| Adding Insult to Injury

Profit margin control is a price control mechanism, but in disguise

Last week, the Egyptian government formed "a cabinet-level" committee to set profit margins in order to control basic goods' price increase. While the government did not specify further details, the Egyptian prime minister explained that this is not a price control. we believe that profit margin control is effectively a price range control mechanism that ultimately leads to the same outcomes of price controls.

Price range control would lead to commodity shortages, parallel market emergence; Negative signal for investors; Inefficient allocation of public resources

In 1970, the United States imposed wage and price controls in order to fight high inflation (around 5%). It ended up with considerable failure. By late 70's when the controls were removed, the US annual inflation rate went double digit. Disrupting normal market dynamics led to shortages of goods across the board. Consequently, the fact that such a measure is temporary raises public inflation expectations in the future, which in return increases demand and decreases supply. Another more recent example is the Venezuelan experience, which imposed a 30% maximum profit margin in 2014. Two years later, thousands of Venezuelans crossed the borders to Colombia to buy food and medicine. In the case of Egypt, applying the same policy to a select basket of goods, or basic goods, won't guarantee a different outcome. Furthermore, such an approach would provide a negative signal for foreign and local investors by the time the government is working hard to raise ease of doing business in Egypt. Finally, the efficient allocation of resources to define, watch and update profit margins will prove challenging and will definitely not be implemented efficiently enough to guarantee reasonable pricing.

What is the answer then to double digit inflation?

We strongly believe that inflation could be better addressed through:

(1) Controlling the budget deficit. We have illustrated previously how the ongoing deficit monetization by the government fueled inflation (See "Rearranging the Egyptian Fiscal Puzzle," published on October 10);

(2) Improve market competitiveness and efficiency. Fighting monopolistic practices, through Egyptian Competition Authority, rather than direct intervention in the market will enhance market functionality. Accordingly, haphazard price escalation would be avoided, but efficiently.

(3) Maintaining Central Bank independence. The mandate of the Central Bank of Egypt (CBE) includes maintaining price stability over the medium term, rather than exchange rate stability or budget deficit management.

In conclusion, we believe that price range setting/margin control would eventually backfire

Inflationary pressure following the implementation of a more flexible exchange rate and cutting fuel subsides would not pass unnoticed. The simplest economic logic and previous experiences imply that a government can only minimize the repercussions of the aforementioned measures on some people (low-income segment), but it is impossible, unrealistic an incorrect to safeguard everyone.

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