The key driver for saving or borrowing is the real interest rate

Deciding on whether to consume or save, nominal interest rates provide an incomplete picture. Future inflation expectation plays a decisive role. If next year's inflation rate is expected to decline leading to a positive real interest rate, this implies an incentive for households to save (and vice versa). On the other hand, a negative real interest rate due to high inflation expectation would lead corporations to borrow more today. The logic is quite simple; the purchasing power of the borrowed amount will be higher today than the repaid amount at maturity. Accordingly, we believe that the real interest rate is a truly vital gauge of economic agents' saving/borrowing decisions. On the broader impact on the economy, shifting from consumption to saving will ease the demand-pull inflationary pressure. However, higher inflation expectation will push the demand higher, leading the actual inflation rate to accelerate as the aggregate supply would take more time to respond to the increase in the demand. Therefore, guiding the inflation expectation is crucial for the monetary policy to achieve its price stability mandate (Graph 1).

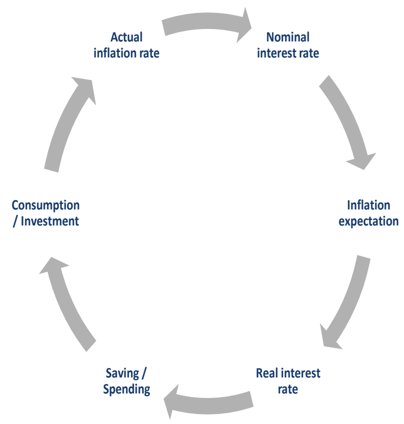
Real interest rate for households is positive, while short-term corporate borrowing is less-expensive than the longer term

Liberalizing the Egyptian pound exchange rate on November 3, the Central Bank of Egypt (CBE) raised its main policy interest rates by 300 bps. Automatically, commercial banks initiated new 1-year saving certificate instruments that offer a 20% per annum, in addition to raising the 1-year corporate loan rate to an average of 16.5% per annum. Using our inflation rate projection for Egypt, households enjoy positive real interest rate on different saving certificates. Meanwhile, short-term borrowers can still benefit from the current marginal negative real interest rate, despite the high nominal interest rate. On the other hand, we estimate the long-term borrowing cost to be relatively an expensive option (Chart 1). This partially explains the government's tendency to favor short-term treasuries over long-term issuance.

Tightened monetary and fiscal policies are in line with the broad macroeconomic rebalancing framework to curb consumption towards more investment

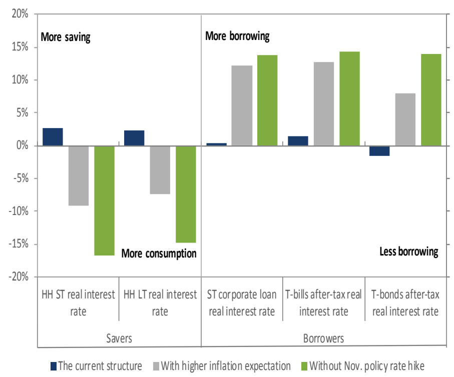
Positive real interest rates on saving certificates encourage household savings (versus consumption), in addition to supporting financial inclusion (Chart2). On the other hand, the nearly zero real interest rates on short-term corporate loans still support the private sector borrowing to weather the temporary exchange rate shock. In that context, we believe that the private sector's appetite for credit remains negatively affected by the transitory uncertainty following the implementation of the economic reform measures in 1H FY2016/17. Moreover, preferential nominal interest rates provided to the SMEs and tourism-related businesses help make their borrowing less costly in real terms.

Graph 1| Guiding inflation expectation is crucial for the monetary policy to achieve its price stability mandate



Source: Pharos research

Chart 1| The current real interest rate structure is in line with the broad macroeconomic rebalancing framework



* (+ve) indicates gains, (-ve) indicates losses

** Based on the latest WEO average inflation forecast

Source: Central Bank of Egypt, IMF WEO, Pharos research

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Was the CBE's preemptive nominal interest rate hike, in addition to other monetary policy instruments useful in curbing inflation?

To answer such a controversial question, we reiterate three facts:

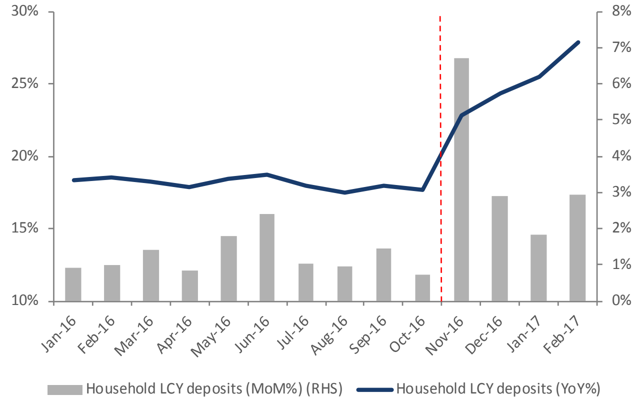
A. The core of the Egyptian double digit inflation rate is a demand-pull inflation, which has been mainly attributed to a double digit budget deficit.

B. The first round effect of the exchange rate overshooting and fuel price hike (cost-push inflation) is inevitable and transitory, hence, the monetary policy role is to contain the second round effect.

C. The Egyptian economy remains a cash-based one. This means that the monetary policy transmission mechanism will take more time to deliver the needed policy outcome. Another important factor is the relatively lower negative impact of a nominal interest rate hike on cash-rich private sector corporations.

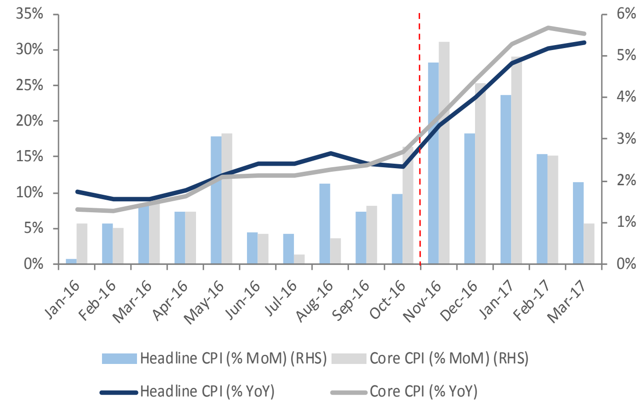
In the absence of the CBE's preemptive nominal interest rate hike, besides excess liquidity absorption auctions, the real interest rate would have turned negative across the economy (Chart 1). Accordingly, all economic agents would rush to consume more over the short-term to make for the purchasing power loss in the future. This would have led the monthly inflation rate to rise indefinitely pushing the annual inflation rate acceleration beyond the current high level. The recent monthly inflation rate path confirms that the CBE's preemptive nominal interest rate hike, despite the implied fiscal interest payment pressure, is gradually working alongside the fiscal discipline and pro-growth measures to bring the inflation rate down.

Chart 2| Households local currency depostis rose significantly following the CBE's 300 bps interest rate hike in November 2016



Source: Central Bank of Egypt, Pharos research

Chart 3| The monthly inflation rate continued to decelerate from 2.7% MoM in February to 2.1% MoM in March, recording the slowest pace since the EGP flotation



Source: Central Bank of Egypt, Pharos research

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