Another 200bps Policy Rate Hike

May’s 200bps Hike was not a Fully Preemptive Move

July 09, 2017

The Central Bank of Egypt (CBE) decided to raise its policy rates by an additional 200bps at the meeting concluded last Thursday. The MPC statement explained that the recent fiscal consolidation measures, which included energy products' price hike and a 1% VAT increase, posed upside risks to the inflation outlook. **Such revelation implies that May’s 200bps was not a fully preemptive move as we assumed on our MPC watch. While we did not expect the timing of this nominal interest rate hike, yet we advised our clients in various reports not to rule out another policy rate hike over the short-run (Please, revisit our note: The Challenge of Bringing Down High Absorption).**

The debate over using the short term interest rates to curb inflation is back in town

The monetary policy transmission mechanism weakness in Egypt is no news. The debate over using it in order to reduce the current high inflation went viral since May’s 200bps policy rate hike. **In our view, a valid approach, albeit not an equity market friendly, suggests that when the brakes are soft, the driver should push the pedal down harder in order to reduce the speed of the car to the desired/targeted level. Hence, using monetary policy more aggressively.** Meanwhile, we note that curbing inflation in Egypt requires various measures, which entails the collaboration of different governmental bodies. The CBE, which is responsible for the monetary policy and mandated to achieve price stability, would initiate monetary tightening using all tools in hand. Such tools include the short term policy rate, in addition to absorbing excess liquidity via deposit auctions. The Ministry of Finance, which is responsible for the fiscal policy, would apply tight fiscal policy in order to bring the budget primary deficit downwards. The Ministry of Investment to actively improve the ease of doing business, which is the key objective of the newly approved investment law. Attracting more investments will accelerate economic growth, which will help curb the high inflation rate. Other governmental entities (I.e. the Ministry of Trade, the Competition authority, etc.) are required to undertake further structural reforms to evade monopolistic practices, ease access to markets, and minimize production waste, amongst other things.

We expect the annual inflation rate to reach 14.6% in 4Q 2018, within the CBE’s target range of 13% (+/- 3%)

We restate that the inflationary reaction to the recently executed fiscal reforms will last for 3 months before the annual inflation rate starts decelerating as the general price level stabilizes, in addition to the expected favorable base effect towards year end 2017. We also reiterate that the first-round effect of the energy subsidy cut is inevitable and transitory. Hence, the policy interest rate hike is meant to absorb the demand-pull second-round effects. Accordingly, we expect the annual inflation rate to reach 14.6% in 4Q 2018, which remains within the CBE inflation target range 10-16% in 4Q 2018.

We revise our fiscal deficit forecast higher to 10.2% of GDP, while maintaining our primary deficit projection at 0.1% of GDP in FY2017/18

We estimate such policy rate hike to be temporary, before the CBE starts monetary easing by December 2017 as inflationary pressures decline. Accordingly, we expect the total budget expenditure to go up by c.EGP13 billion to reach EGP1266.9 billion in FY2017/18. Accordingly, we raised our forecast of the budget deficit to 10.2% of GDP in FY2017/18. Most importantly, we maintained our primary deficit projection, which excludes the interest payments, at 0.1% of GDP in FY2017/18. **Furthermore, we believe that more foreign inflows in the EGP-denominated treasuries will help minimize the negative impact of July's 200bps nominal interest rate hike. We note that following May's 200bps policy rate hike, the short-term treasury yield rose from an average of 19.3% in April to 20.4% in June (+1.1% increase).**

The impact of the policy rate hike on the EGP exchange rate will be limited as the CBE tends to keep the hot money inflows outside the system

The 200bps nominal interest rate hike would automatically raise foreign investor's appetite to the EGP-denominated treasuries. However, the fact that the CBE keeps such additional FCY liquidity outside the banking system implies that the impact on the exchange rate will be limited. Meanwhile, more foreign fixed income inflows would raise the sterilization costs as the CBE will pay higher interest rate to absorb the excess domestic liquidity via the variable interest rate deposit auctions. Indirectly, the recently introduced tighter monetary and fiscal measures will ease the consumption growth. This would support the exchange rate stabilization by minimizing depreciation risk.

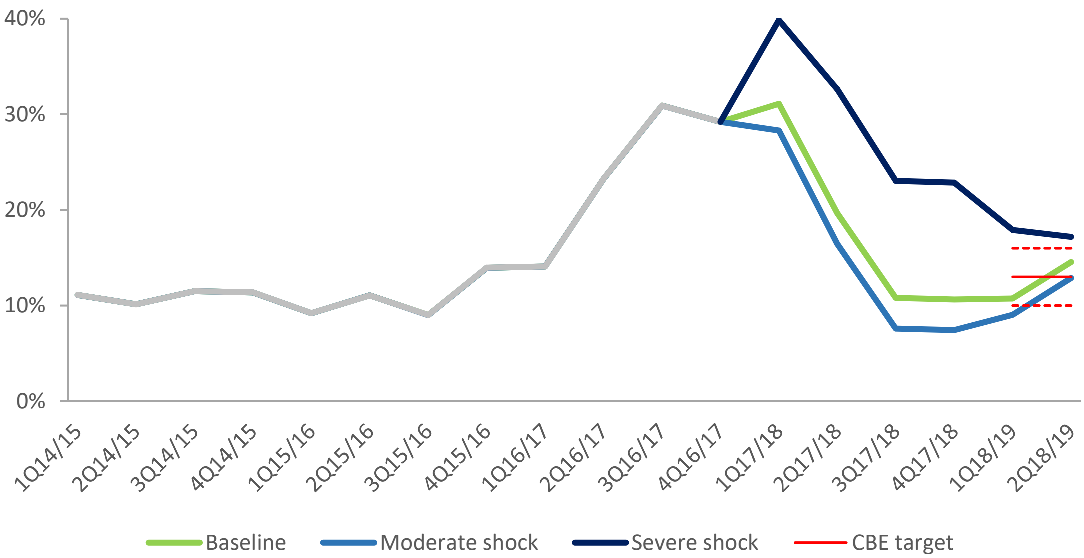
Winners remain: household savers, cash-rich companies and potentially commercial banks; Losers: highly leveraged companies

We reiterate that the debt level in the economy is small. Therefore, the negative impact of the consecutive nominal policy rate hikes on the broader economy will be limited. As further monetary and fiscal tightness took effect, consumption growth will be further hit. While highly leveraged companies will bear the brunt, we note the non-performing loans (NPL) remain under control through a stable provisions coverage ratio. Hence, we expect no grave risk to the financial stability following the consecutive policy rate hikes. Moreover, the preferential low nominal interest rates provided to SMEs/tourism industry would minimize the negative impact of the policy rate hikes on the employment level in such important sectors. On the other hand, commercial banks can be key beneficiaries if they managed to pass on a smaller portion of the policy rate hike onto deposit rates.

Equity market should witness a short-term pressure, but the medium term fundamentals still hold

We have examined the effect of historical rate hikes on the equity market, which have been roughly limited to 2% down for every 1% hike in policy rates. This means that the market might go down early this week by 2-4%, but such a drop will create attractive opportunities for rebuilding positions. In addition, a positive report by the IMF to follow the disbursement of the second loan tranche would absorb any potential negative shock of the policy rate hikes. Finally, we reiterate that we have been using a cost of equity of 24% for FY2017 (based on an after tax risk free rate of 17%) and gradually leveling off to 15% in 2021. We believe that it should not be reviewed upwards at this point.

We expect the annual inflation rate to reach 14.6% in 4Q 2018



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