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Deciphering the Din of Battle

As the world is edging closer to declare victory in one battle against COVID-19, most central banks and monetary authorities around the world are gearing up to face yet another coronavirus variant and its tail risks. In light of the growing virus-driven global inflationary pressures, the Monetary Policy Committee (MPC) of the Central Bank of Egypt (CBE) heads into its upcoming meeting tomorrow, bearing in mind a major concern of how to balance between anchoring inflation expectations and facing the uncertainties over pandemic-driven tail risks of inflation and tightening global monetary conditions.

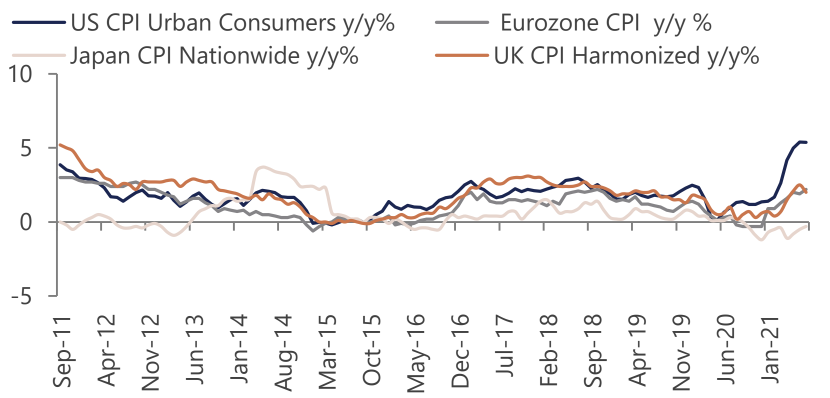
Domestic inflation is just the tip of the iceberg: August inflation reading in Egypt was not that alarming, despite the acceleration in headline annual inflation. It was expected, given the unfavorable base-year effect and the pressures observed on some food items, mainly agricultural. Moreover, monthly inflation was muted, and core readings were declining in both monthly and annual terms. Therefore, Egypt, unlike most the EMs, still has room to deliver another rate cut, as inflation expectations remain within its targets. However, external vulnerability, large external financing requirements, along with the current emergence of COVID-induced inflation everywhere will fuel the argument against further rate cuts.

At the current juncture and going forward, to predict the trajectory of the monetary policy and MPC's decisions, we should first sift through the following factors with a fine-tooth comb:

1. **The speed and robustness of the economic recovery:** Egypt's annual growth defied expectations by hitting 3.2% in FY21, showing significant resilience in face of the COVID-19 crisis. The outlook is still positive for economic growth in FY22, yet the heavyweight sectors of the economy (including manufacturing, oil and gas, and construction) are still exposed to COVID-related supply disruptions. Moreover, the outlook of the private sector recovery activity is still clouded by the accumulated pressures of the surge in global commodity prices, shipping costs, and supply bottlenecks.

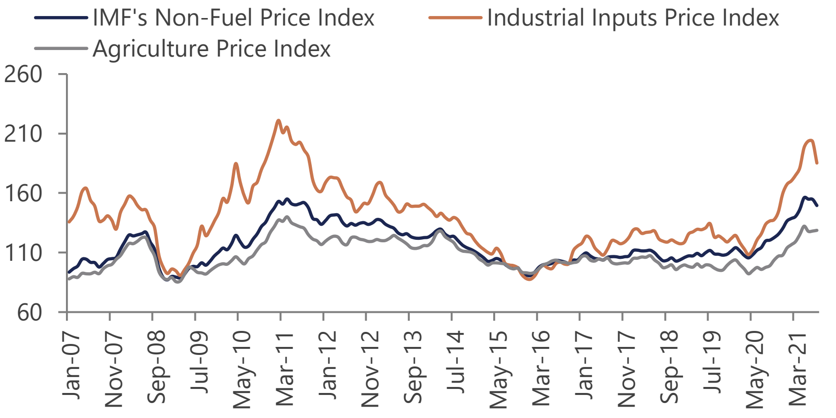
2. **External vulnerability:** The significant debt obligations in 2021 started to weigh on the country's external buffers in July 2021, as debt service payments are set to surge to USD13.2bn in H2 2021, c.56% of which consists of maturing GCC countries deposits at the CBE, which stood at USD15bn at end of H1 2021. These obligations drove net foreign assets (NFAs) at Egyptian commercial banks to continue falling in July, in tandem with a significant drop in non-official reserves. (See our NIR report.) This came even as the country continues to attract carry trade inflows, especially into short-term sovereign debt. External accounts are subject to further pressures as structurally tenacious trade deficit will widen under the pressures of global commodity prices and skyrocketing shipping costs. Indeed, Egypt recently sought to raise its funding package from the International Islamic Trade Finance Corporation from USD400mn to USD1.3bn to import basic commodities, such as wheat and sugar. We note that Egypt relies on foreign capital inflows and external borrowing to finance its current account deficit (CAD) and growing debt obligations. This, in our opinion, will keep the country vulnerable to external shocks and global financial conditions.

Figure 1: Global inflation rates heading towards historical records



Source: Bloomberg.

Figure 2: Global inflation seen rising across different sectors

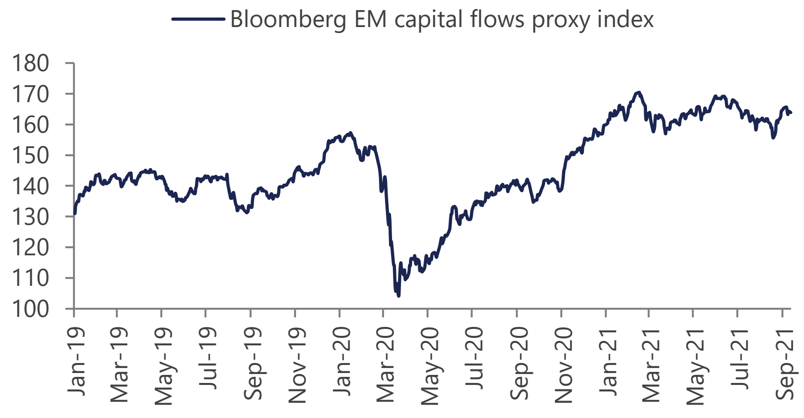


Source: IMF.

3. **The pass-through rate of producer prices to consumer prices:** Evidence is accumulating that price pressures facing Egyptian companies are increasing. According to Egypt's PMI survey in August, the input price inflation picked up to its highest level in two years. The pass-through of price inflation from producers to consumers will depend on factors such as companies' pricing power and labor market conditions. The ongoing improvement in employment indicators, as highlighted the PMI report, and relatively weak competition dynamics in the economy will likely encourage companies to pass on the increase in costs to end consumers.
4. **EMs monetary conditions:** In the face of growing inflationary risk, some major EM central banks started to normalize their monetary policy to keep inflation expectations anchored around their targets. This trend will likely gain further momentum as the world is getting ready for Fed to announce tapering its ultra purchasing program by the end of 2021. While Egypt still does not have to follow suit, keeping a lucrative rate on carry trade is crucial to attract needed funding for CAD and to avoid potentially destabilizing capital outflows.

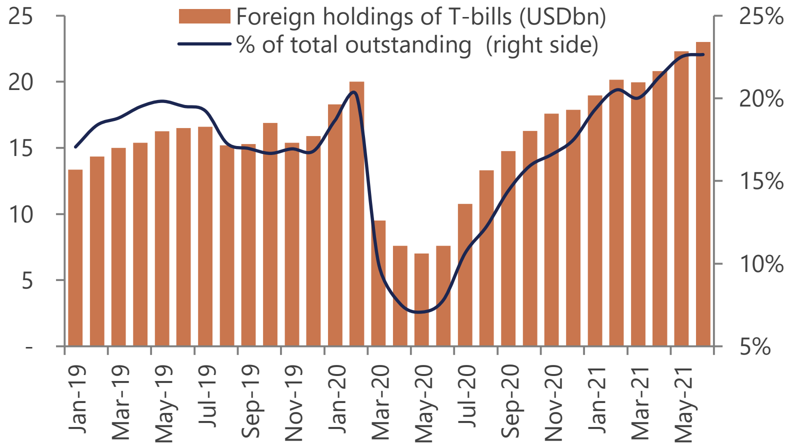
In a nutshell, Egypt's structurally-high financing needs at the time of growing risk of tightening global conditions will keep the monetary authority cautious. The path for easing became bumpier as COVID inflation spread everywhere around the world and supply chains are still snarled. The CBE's next move will mainly depend on the unfolding of global dynamics, including the Fed's tapering announcement and the persistence of supply constraints. Therefore, a rate cutting decision will remain surrounded with uncertainty; hence, the status quo is the best strategic decision.

Figure 3: Recent capital inflows volatility in EMs



Source: Bloomberg.

Figure 4: Egypt's T-bills still attracting inflows



Source:: CBE, Prime Research.

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