

When “Bad” Inflation Clouds the Path of “Good” Inflation

While central banks around the world are caught by the sudden upturn in inflation, the CBE still has room to preserve its current stance: The Monetary Policy Committee (MPC) of the Central Bank of Egypt (CBE) heads into its last meeting in 2021 with two inflation readings in October and November within its target. Still, forward-looking expectations are still anchored around that target. Domestic inflation figures, on the other hand, indicate that the global inflation environment is still adding pressure. Indeed, the “pandemic” is not over yet, and the transitional phase to “epidemic” seems to be more bumpy than previously thought, with another variant hit threatening the recovery path.

Between a rock (active pandemic-related risks) and a hard place (agitated global supply-driven inflation), the monetary stance should remain patient: While a tightening monetary policy is the ultimate choice before central banks to control inflation, we must remember that it is only effective if we are talking about “good” inflation—the kind that is driven by domestic demand recovery and strong labor market dynamics. Thus, we believe it is still early for the CBE to consider shifting its current accommodative stance, as the inflation outlook is still dominated by a bout of “bad” inflation fueled by global supply disruptions.

We have five reasons to believe the CBE will err on the side of caution and keep its current stance on hold in its upcoming meeting and more likely until end of H1 2022:

(1) Inflation remains within target, with focus on core inflation. Annual core inflation, which we use to trace the recovery of household spending, has been on an upward trajectory since September following a slight fall in August. Yet, it was mainly driven by the effect of global food prices

on some core food items, seasonality factors, and rebounding service demand. Over the coming months, our headline inflation expectations, which are still anchored around the CBE’s target, will be guided by core inflation.

- (2) The emergence of a new variant and its trajectory on the ground continue to cast uncertainty on the growth outlook.** The emergence of Omicron reminded the CBE and other central banks around the world that health risks are still significant, so it might be risky to act solely on the fears of misplacing inflation expectations. Keeping an adequate level of support is also crucial given the level of uncertainty that is still obfuscating the economic outlook.
- (3) Limited fiscal space and the need to keep interest payments in check.** Egypt has recorded its first primary deficit in years in Q1 FY22 (c. EGP6.5bn), and the overall deficit was up to 2.3% of GDP (vs. 2.1% in Q1 FY21). Moreover, the increasing cost of external borrowing will drive more attention to focus on local sources of funding.
- (4) The country’s dependency on external funding and capital inflows.** The fading transitory inflation narrative and continued upward pressures on underlying inflation in advanced countries raise concerns about the spill-over effect on global monetary conditions and the country’s external vulnerability to external shocks.
- (5) Advanced economies’ monetary policy remains accommodating.** At its December meeting, the Fed is expected to adjust the pace of its asset purchases, paving the way for rate hikes earlier than expected by mid-2022. Until then, we are still seeing a certain level of liquidity support and a loose monetary stance.

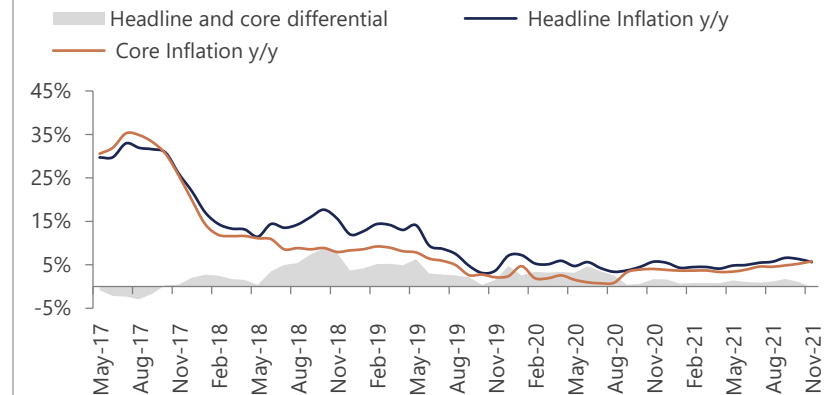
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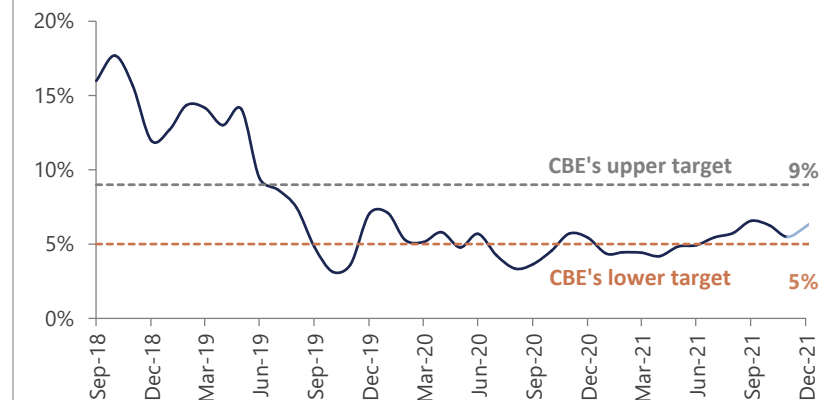
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Figure 1: Core inflation continued its upward trajectory, signaling that inflation is expanding beyond volatile items



Source: CBE, CAPMAS, and Prime Research.

Figure 2: Inflation will end 2021 within the CBE’s target



Source: CAPMAS, Prime Research.

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