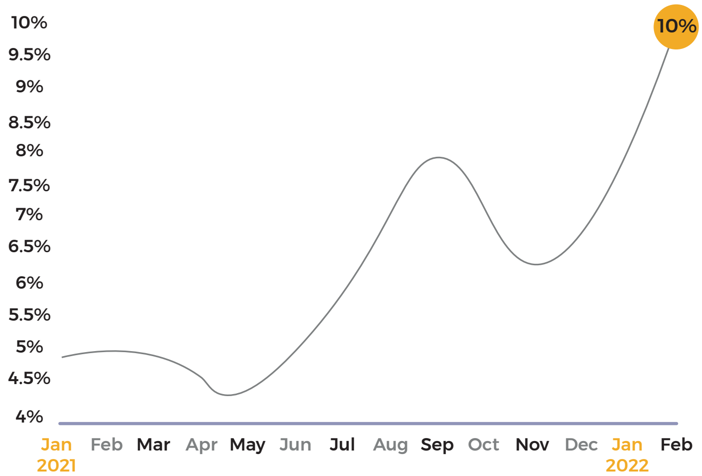
Is the Current Inflation Wave Leading to Another EGP Devaluation?

Markets globally, including in Egypt, are witnessing a rise in inflation rates, which were already on an upturn, due to the pandemic and the Russian-Ukrainian conflict. According to CAPMAS, the nationwide annual inflation rate recorded 10% for February 2022, compared to 4.9% for the same month last year. This is considered the highest in three years and exceeded the limit set by the Central Bank of Egypt at 7 percent (±2%) through the fourth quarter of 2022. JP Morgan predicted that Ukraine war and other ongoing challenges would extend the period of high inflation. **Still, there is a bigger fear that is haunting Egyptian market– Are we going to witness another devaluation of the Egyptian Pound?** The good news is that this might not be the only solution to control the current inflationary pressures.

The annual inflation rate in Egypt over the last 14 months



But First What are the Main Factors that are Feeding through Inflation Channel in Egypt in 2022?

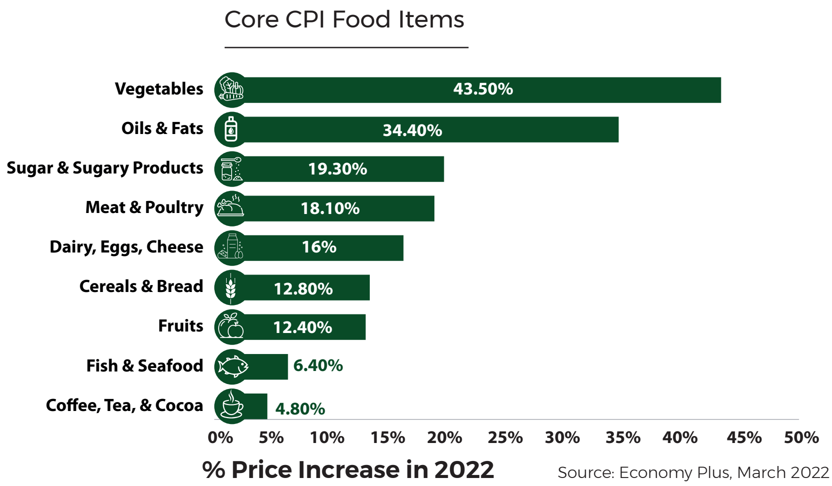
I. Increase in Oil Prices:

Most forecasts predict that oil prices will keep rising for the time being with uncertainty over when they will stabilize, especially with geopolitical tensions running high. Oil price fluctuations may not be in Egypt's interest given that it's a net importer of crude oil and petroleum derivatives. Petrol prices generally move in sync with crude oil prices and the exchange rate of the pound against the US dollar. So, with brent crude oil rising to $130 a barrel on Mar. 8, we can see another rise in the price of gasoline by about 10%, which is the maximum allowed for a single increase in fuel prices (1). The higher global oil prices have already prompted Egypt's government to increase petrol prices at the pump by LE0.25 per litre, marking the fourth hike in a year. Yet, some economists fear the possibility of raising diesel prices as it will certainly have a significant negative impact on the inflation index. Adding to this, housing and utility prices rose by 4.7% y-o-y, driven by higher energy costs, while transport costs rose by 4.9% (2). Also, the higher oil price would push food prices as the prices of food commodities move according to the movements of oil and petrol prices, given that food commodities represent 34% of the basket measured by the consumer price index.

Oil could vault as high as 150$ a barrel, veteran analyst warns, as undersupply meets surging demand (3).

II. Increase in Food Prices:

Last week, the global food price index reached an all-time high, soaring 24.1% above its level the year before (4). For Egypt, the increase in annual inflation was predominantly driven by 17.6% increase in food and beverage costs, especially with the increasingly complicated Russia-Ukraine crisis (5). According to Egypt's Finance Minister, before the crisis in Ukraine, we used to buy a tonne of wheat for 226 euros, now it costs 363 euros. Given that Egypt is one of the largest wheat importers in the world, wheat prices worldwide could force the government to revise its bread subsidies to protect its finances. Yet, lifting bread subsidies will likely push Egypt's inflation rate to 12% (6). While tackling the bread subsidy may not be considered in the short-term, the government has already raised the prices of other commodities such as sugar and cooking oil that many people receive as part of the food-subsidies program. The surge in food prices was also prompted by the government's decision in December to raise the price of butane gas--used for cooking by most of Egypt's poorest households along with the price of subsidized vegetable oil.



Source: Economy Plus, March 2022

III. Growing Fiscal Deficit:

J.P. Morgan Commodities research team now see fiscal deficit wider at 6.6% of GDP in FY22 from 6.4% previously. This is attributed to the rising commodity prices and higher import costs. The rapid rise in wheat prices alone had an immediate impact on the government's fiscal accounts as the finance minister recently announced that the state's budget for wheat purchases would increase by EGP15bn. This has actually delayed state's efforts to bring down the debt-to-GDP ratio, which is elevated in Egypt. The total debt-to-GDP ratio reached 90% in 2020, placing significant strains on the state budget, as the cost of interest on loans will consume 31.5% of state expenditure in 2021/2022 (7). The situation is compounded by an underperforming non-oil private sector, which has been contracting for most of the past 5 years, due to weak local demand and export orders. This weakens the tax base of the state, further increasing the pressure on government to cut public spending in order to meet its debt commitments and maintain its creditworthiness. Before the crisis, Egypt had been working to sustain appetite for its treasury bills to finance current account and budget deficits. Yet, many investors are concerned that emerging markets, including Egypt, may be more susceptible to any disruptions resulting from Russia-Ukraine crisis. According to the bankers, who declined to be named, foreign investors had pulled about $3 billion out of Egypt since the beginning of March (8). Also, the Egyptian Stock Exchange revealed that foreign investors sold around $1.19 billion of Egyptian treasury bonds in just three days, according to the Reuters statement.

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IV. A Sharp Rise in Input Costs:

According to the IHS report on Egypt, Egypt's PMI dropped to its lowest reading since April 2021 at 47.9 but rose again in Feb to reach 48.1, which is still below the 50-threshold. This indicates a solid decline in overall business conditions and the sharpest decrease in non-oil activity in Egypt since June 2020. Sub-indexes showed a decline in output and new orders, as well as employment and purchasing activity, with firms struggling with another sharp rise in input costs. Input cost inflation was at its the second fastest in over 3 years in Dec. 2021 (9). According to the IHS Markit report, raw material costs continued to climb, with some surveyed companies highlighted price mark-ups of over 10% to protect their profit margins. For example, according to Masrawy, Ezz Steel increases steel prices by EGP 2k/ton over the past month, while the Suez Steel Company hiked its prices by around EGP 1.5k (10). Also, increased shipping and energy prices continued to burden companies with rising input costs. So, it is not just food prices that are rising; other areas of the economy such as manufacturing and construction are facing higher input costs as the prices of raw materials rise. All these factors together are not only constraining activity over 2022 but have also led companies to reduce their staffing levels, resulting in a fourth successive monthly drop in employment.

Expected Measures that Egyptian Government Would take to Limit the Impact of Current Inflation:

It is essential that nations find ways to cope with inflation or else the world will need to "brace itself for a recession in 2023 or 2024," according to the latest World Economic Outlook report. **So, what are the expected scenarios that Egypt might go through in an attempt to control current inflation wave?**

1 Issue More Treasury Bonds:

For the current fiscal year, the budget deficit is planned by the ministry to be financed through treasury bills and bonds and through international and Arab loans. The Ministry of Finance intends to issue bids for treasury bills and bonds worth EGP 186bn (11). An official source at the Central Bank of Egypt has stated that foreign investors are returning strongly to the Egyptian market since the start of January 2022, adding that 970$m have been injected into Egypt as of 16 January (12). Also, Egypt has rejoined JP Morgan's Emerging Markets Bond Index in January 2022 after being delisted from the index in 2011. The return is in line with the Egyptian government's efforts to reduce the cost of public debt as this action will allow large investment funds and foreign investors to invest in Egypt's debt instruments in local currency. The Finance Minister expects around 1$ billion in new investments to be pumped in the Egyptian governmental equity market as a result. Also, Egypt aims to sell around USD 500 mn of JPY-denominated bonds in Japan by the end of June 2022, as part of Egypt's debt diversification strategy (13).

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2 Seek Support from Gulf Countries:

Gulf states have played large roles in Egypt's economy for many years. Gulf funds have made up some 10–20% of all foreign direct investment in Egypt over the past decade (14). In 2019, a Gulf newspaper quoted an unnamed official at the Central Bank of Egypt on the sum of assistance Gulf states had given since 2011: $92 billion; $7.5 billion in deposits from Saudi Arabia, $5.9 billion from the UAE, and $4 billion from Kuwait, as well as more than $30 billion in loans to finance petroleum purchases (15). Given the current situation, Egypt might seek support from gulf states, and we are already seeing some, if not all, of these deposits' maturities have been extended. Data from CBE showed the renewal of the maturity date of a Saudi deposit of $2.3 billion, to be paid in October 2026 instead of this fiscal year. The report also revealed the extension of a Kuwaiti deposit of $2 billion for a period of one year, which was due for payment in September 2021. Back in 2016, the value of the local currency plunged from 8.88/$ to 19.62/$ in nearly one month. Yet, as Egypt kept rebuilding its foreign reserves primarily through borrowing, the value of the local currently improved over the last 5 years. The Egyptian pound has been trading at nearly 15.7/$ for almost 2 years.

3 Increase Interest Rates:

Central banks are moving towards reducing monetary expansion and raising interest rates, among other counter inflationary monetary actions in the coming period. CBE was very watchful for interest rates in the US and secondly in Argentina and Brazil since few months now and have been reluctant to increase interest rates as inflation rate didn't exceed the limit set at 7% (±2 %). But with inflation reaching 10% in March and U.S. federal reserve raising their interest rates starting next month and scheduling 3 interest rate hikes in 2022, the gradual increase in interest rates in Egypt would be inevitable. According to Ehab Al-Saeed, a money market expert, the exit of the investors from the market and the process of raising the interest rate in the US market by 0.5% in the upcoming days; are pressure factors on dollar liquidity, which causes direct effect on the value of the Egyptian pound against the dollar. Thus, it is expected that CBE may hike interest rates to 8.75%, at its Monetary Policy Committee meeting later this month, making Egypt's first interest-rate increase since 2017 (16).

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4 Reform Subsidies Scheme:

With inflation and a rapidly increasing population, the subsidy program places a heavy burden on the state. Egypt has been removing state subsidies from fuel and basic food items since it agreed on a reform plan with the IMF in 2016. The food subsidy program currently costs the government about $5.5 billion, with bread subsidies costing around $3 billion a year (17). With the rising global wheat prices, it will cost Egypt up to $950 million more in the current fiscal budget, according to Finance Minister. To guard its upcoming budget from soaring global wheat prices, Egypt is considering replacing a popular bread subsidy with cash payments. However, according to Ali Moselhy, this reform won't come into effect now given the current inflationary pressures. Still, the government is working on a plan for reformed food subsidies in time for March budget preparations, with the intention of improving targeting of food subsidies. In regard to other cost of goods, Egypt has signed a $12 billion IMF loan agreement in 2016, to slowly lift fuel and electricity subsidies, with a plan to phase out electricity subsidies entirely by 2022.

5 Seek Another Assistance Package from IMF:

The question here is: "Why would Egypt resort to seek another loan from IMF?" Well, a short answer is that the IMF has assisted Egypt to regain its footing to restore macroeconomic stability and promote inclusive growth over the past 6 years. Egypt received two loans from the IMF in the past 6 years. The first came in 2016 for US $12 billion, and the second in 2020 for a total of $5.2 billion to face the severe contraction amid the COVID-19 pandemic. The main goal of the policies supported by the program is to fix external imbalances and reduce the budget deficit. Hence, Egypt has been in talks with the IMF over the past few months to look into the possibility of securing a new loan, due to Egypt's high exposure to external financing. While, sources did not mention the expected value of the loan, they mentioned that the IMF refused Egypt's request that the loan be negotiated under the terms of the EFF program as the Egyptian economy is not facing a major crisis or an exceptional situation (18). The same source said that the mechanism currently being discussed is the SBA, as with the 2020 loan where financing is provided over a shorter period of time than the EFF, and the repayment period is no longer than 5 years.

6 Devaluate Egyptian Pound:

There is an on-going scenario that Egypt might resort to the devaluation of its pound to contain the upward-creeping inflation. While Egypt's economy is under a great threat, the country is on a much firmer financial footing than it was in 2016, making this scenario much more unlikely. The remittances, along with the revenue of the Suez Canal, the tourism sector, and foreign investment are the main sources of foreign currency coming into the country. Luckily, these factors are either growing or slightly affected by the negative repercussions of COVID-19, global inflation and Russia-Ukraine war. For example, there is an increase in Suez Canal's revenues by 15.1% during February 2022 and remittances rose by 6.4% in 2021 to reach US$ 31.5 billion. Still analysts at investment bank JPMorgan mentioned that a steep devaluation of Egypt's pound was likely to be required, estimating that EGP was currently more than 15% overvalued and may trade at EGP 17.5 against the US dollar by the end of 2022 (19). JPMorgan laid out 3 scenarios on the potential size of such a devaluation; (I) No devaluation, (II) Small Devaluation; like 2014/15 when authorities allowed the currency to depreciate by roughly 5%, (III) Larger Devaluation as part of a new IMF package, resulting in a weighted probability depreciation of 8.5% from current spot. Also, according to Maged Shawky, Chairman of Catalyst Partner, "While Egypt's economy is under a great threat, the country is on a much firmer financial footing than it was in 2016, making devaluation scenario much more unlikely. And we may expect limited depreciation, which is healthy for the economy"

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