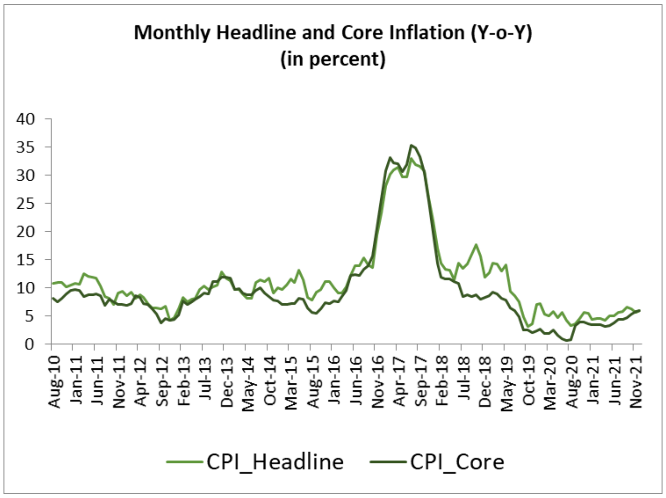
Macro-Note Series

"Inflation Note"

Negative Output and Money Gaps Contribute to Stable Inflation

Monday 10th of January 2022

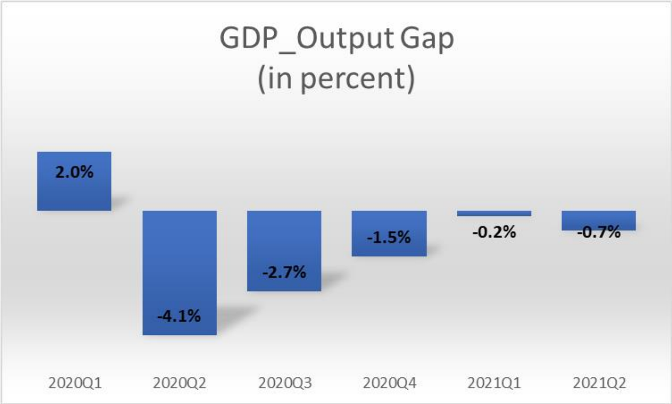
Recent dynamics in headline and core inflation … Urban headline inflation (Y-o-Y) inched up to register 5.9% in December, compared to 5.6% a month earlier. The increase is attributed primarily to unfavorable base effect from previous year. The monthly dynamics showed a decline of 0.1% in December compared to a positive figure of 0.1% in November and compared to negative 0.4% in December 2020. Meanwhile, core inflation accelerated in December to record 6.0% (Y-o-Y) compared to 5.8% a month earlier. This came on the back of higher m-o-m rate of 0.2% in December 2021, compared to zero during the same month of the previous year.

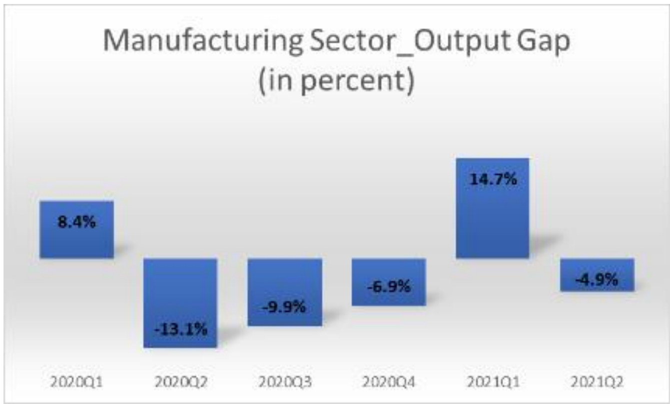


Source: CAPMAS and Central Bank of Egypt.

…Sources of demand-driven inflation … December's dynamics resembles that of November in which the deceleration in monthly core inflation emerged from retreated seasonal factors attributed to decelerated prices of food items other than fruits and vegetables that usually occur during that time of the year. In addition to favorable pass-through effect from stable FOREX market.

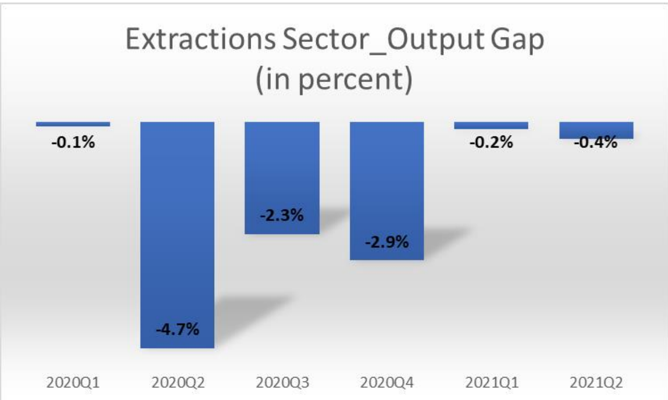
The decomposed series indicated that both seasonal and irregular factors have pulled down core inflation during December 2021. This occurred despite the positive contribution of both inflation expectations and the cyclical factors accounting for 0.48 and 0.38 percentage points, respectively.

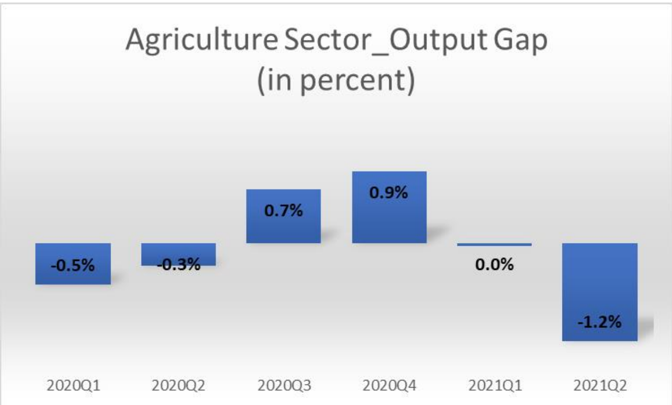




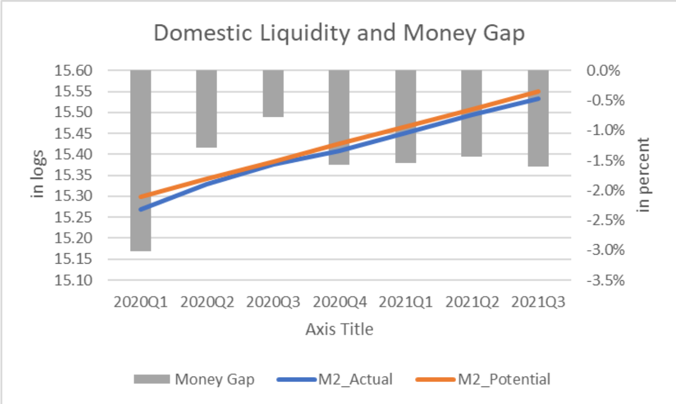
…Output Gap and Inflationary Pressures … Estimated potential output -after excluding the end points for biasedness- revealed that they are relatively above the actual levels for six consecutive quarters. This implies unlikely existence of underlying inflationary pressure in the near future from the demand-side and the business cycle.

The main sectors -as displayed in the following charts- which constitute about 50% of the total GDP also depict slowing actual figures that are well below the potential levels. In other words, they exhibit negative output gaps over 2020 and the first half of 2021, backed by the repercussions of COVID-19 and the economic slowdown that accompanied the pandemic.





The same conclusion has been induced from the money gaps. As such, these dynamics would put downside risks for the Central Bank and would give it a breathing pause to fix interest rate in the upcoming one or two MPC meetings.



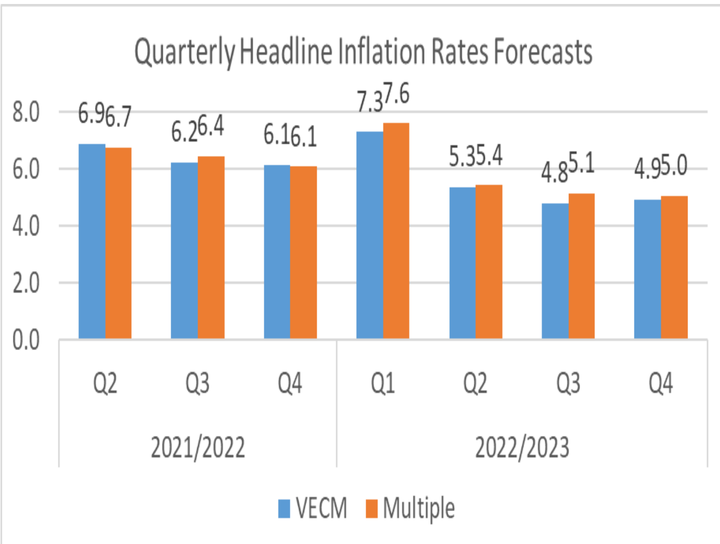
Source: MAP's Estimates, MPED and CBE.

…Forecasts for headline and core inflation … The implemented forecasts present two models, in addition to the average of the two scenarios which are calculated using univariate a multiple model specification and a Vector Error Correction Model (VECM), wherein the estimation period spans from 1Q 2010/11 through 4Q 2020/21.

Headline and core inflation forecasts for FY2021/22… According to the baseline scenario, we still expect that urban headline inflation will be maintained during FY2021/22 at a single digit, albeit it will increase to reach 7.0%. This would be attributed to the favorable pass-through effect from stable FOREX market. Moreover, inflation expectations are broadly managed as obvious from the decomposed core figures accounting for only 0.48 percentage points of December monthly inflation rate. In addition, output gaps and money gaps suggest downside risks to inflation during the upcoming quarters, especially over the short-term.

For headline inflation, baseline forecasted figures are on average ranging between 5.0% and 7.4% for FY2021/22 and FY2022/23.

As such, our forecasts show that short-term inflation will be hovering -on the lower edge- around the target set by the CBE which is 7% (+/-2%) suggesting that the CBE will be able to meet its target, however, conditions might reverse in the medium term.

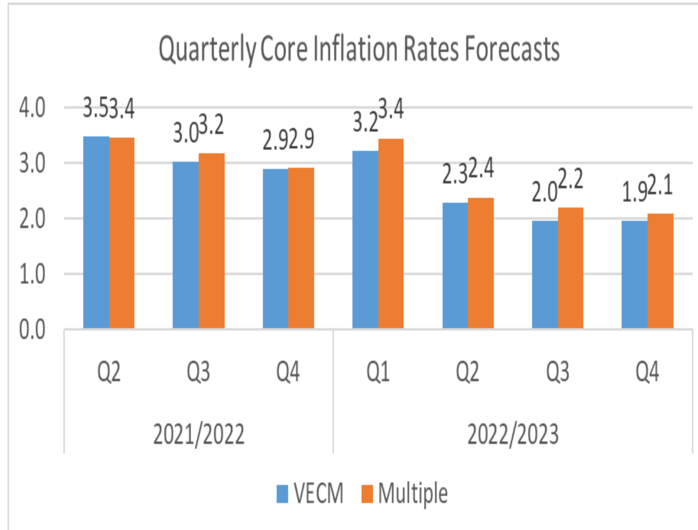


Source: MAP's Estimates.

When shifting to core inflation forecasts, recent dynamics indicate that it will be kept at a single digit for some time, and it will be well below the historical averages. Evidently, we found that it will show a muted rates during FY2021/22 and FY2022/23, to reach an average maximum of 3.5% as per both the multiple regression and the VECM model by Q2 FY2021/22; nevertheless, since then, it will be on the downward trajectory, and it will be fluctuating around a single digit for all scenarios likewise ranging between 2.9% to 3.5%.

Worth noting, our in-house headline inflation forecasts for Q2 FY2021/22 was ranging between 6.7%-6.9%, which is not far from the actual figure of 6.0%. However, the prediction error is higher for the core inflation which materialized at 5.7% during Q2 FY2021/22, compared to our forecasts that ranged between 3.4%-3.5%.

We still emphasis that future dynamics in inflation will partially depend on how the economy will perform on the real activity front along with the dynamics in both inflation rate and FOREX market during the next couple



of quarters.

Source: MAP's Estimates.