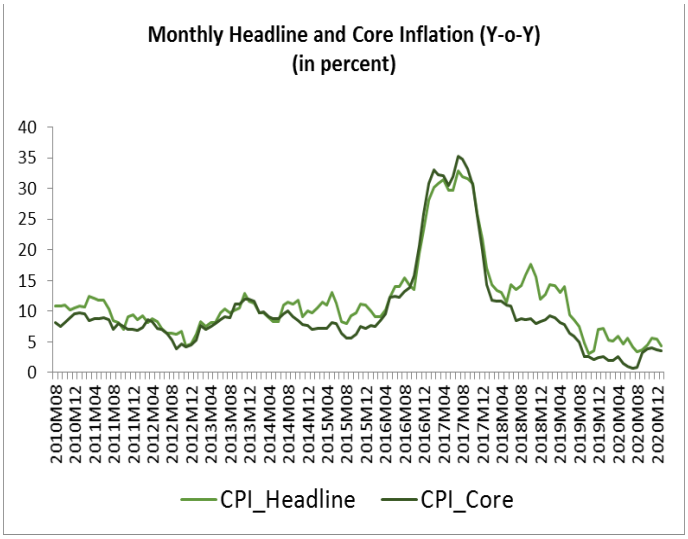
Macro-Note Series
"Inflation Note"

وزارة التخطيط والتنمية الاقتصادية
Ministry of Planning and Economic Development

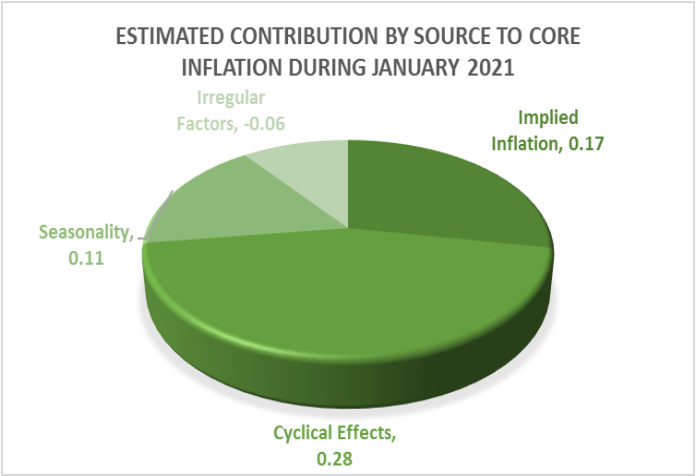
Inflation Still on the Deceleration Mode but Cyclical Factors Manifest Themselves Clear

Recent dynamics in headline and core inflation … Urban headline inflation (Y-o-Y) declined to 4.3% in January, compared to 5.5% in the previous month. The deceleration is driven by monthly developments by -0.4% in January -for two months in a row, compared to 0.7% in the corresponding month. Moreover, core inflation (Y-o-Y) slightly declined to reach 3.6% in January, down from 3.8% a month earlier. This came on the back of an anchored monthly rate of 0.5% in January, compared to a muted rate of zero% a month earlier.



Source: CAPMAS and Central Bank of Egypt.

…Sources of demand-driven inflation … During January 2020, the decomposed series shows that the main source which fuels monthly core inflation during this month is mainly attributed to cyclical factors accounting for 0.28 percentage points out of 0.5%. This can be backed by the fact that economic conditions are relatively getting back to normal, especially that inflation which came back from the spillovers of the irregularities primarily the associated with a limited pass-through effect emerging from the recent slight depreciation of the EGP in front of the greenback during the last two months, which might be transmitted to the inflation rate. Moreover, the inflation expectations or implied inflation has shown a positive contribution of 0.17 percentage points- albeit anchored to a great extent. Also, seasonality recorded a positive contribution of 0.11 percentage points by during January.



Source: MAP's Estimation.
* Normally, seasonal factor estimates appear with nil value in case of annual data, while seasonality is a high-frequency data concept that emerges in monthly or quarterly series.

…Forecasts for headline and core inflation … The implemented forecasts present two scenarios, in addition to the baseline scenario which is calculated using univariate ARIMA model specification. Both optimistic and pessimistic scenarios are induced from a macro-model estimation (refer to the technical annex), wherein the estimation period spans from 1Q 2004/05 through 1Q 2020/21.

Headline and core inflation forecasts for FY2020/21…we still expect that urban headline inflation will be maintained during FY2020/21 at a single digit -albeit with an upward trend, it will be well below the historical average (excluding the overshooting inflation period took place during 2016 and 2017), for all scenarios. For headline inflation, the forecasted figures are on average ranging between 7.3% and 9.6% for FY2020/21.

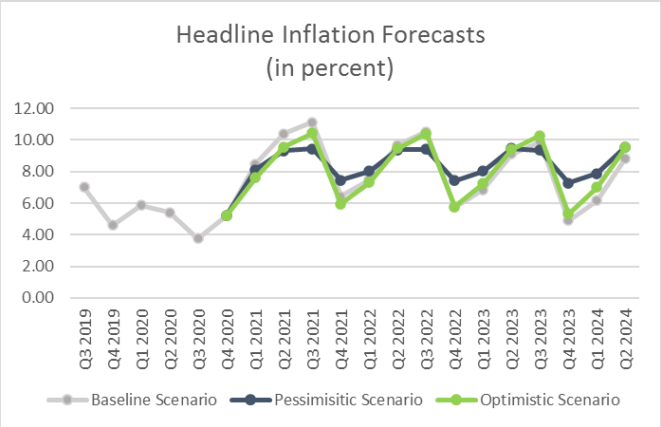
Further, according to the pessimistic scenario forecasts, inflation will pick up -though below the historical average- to hover around 7.6% - 9.6%. The forecasted inflation is motivated primarily from the macro-economic dynamics concerning expectations of tamed GDP growth accompanied but with lower unemployment rate, which improved significantly during Q3 2020 to register 7.3% down from 9.6%. This is expected to be partially offset by having positive money gaps during the period under investigation.

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

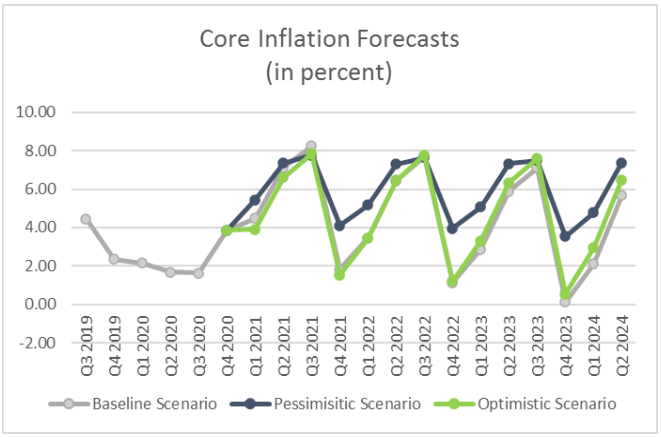
When shifting to core inflation forecasts, recent dynamics indicate that it will be kept well below its historical average of 8.8% for some time. Evidently, we found that it will show a slight pick-up by Q4 FY2020/21, to reach a maximum of 7.4% as per the baseline scenario; nevertheless, it will be fluctuating around a single digit for all scenarios likewise. Business as usual scenario shows that if economic conditions are *ceteris-paribus*, core inflation will be maintained at a record low of 4.3% on average during FY2020/21.

Worth to mention that the displayed quarterly forecasts on the following two panels incorporate the forecasts for GDP figures which entail some extra dynamics emerging from the seasonal nature of the GDP quarterly data.

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.



Source: MAP's Estimates.

Headline Forecasts				
	Baseline	Pessimistic	Optimistic	Average All Scenarios
Q1 2020/21				
Q2 2020/21	**5.24**			
Q3 2020/21	8.47	8.12	7.61	8.07
Q4 2020/21	10.40	9.32	9.56	9.76
Core Forecasts				
Q1 2020/21				
Q2 2020/21	**3.86**			
Q3 2020/21	4.47	5.44	3.92	4.61
Q4 2020/21	7.14	7.35	6.62	7.04

Source: MAP's Estimates.

Technical Annex: Macro Forecasts Summary

1. **Sectoral Real GDP: Factor Cost**

All values were calculated as the nominal values adjusted for inflation using the Headline CPI.

Three scenarios were calculated:

- Baseline scenario: the historical averages for the last 15 years were utilized in a univariate framework.
- Optimistic scenario: the simple average for the univariate analysis of 10 leading sectors, which are: Agriculture, extractions, manufacturing, construction, transportation, real estate, finance, Suez Canal and hotels & restaurants and services were implemented. These five sectors constitute about 50% of real GDP.
- Pessimistic scenario: based on a behavioral function of five proxies for three leading sectors (Suez Canal, transportation and extractions) which are affected primarily from geopolitical issues and the Global pandemic impact especially in the light of the second wave of COVID-19.

2. **Labor Market: Unemployment Rate and Number of Employed**

- Is based on a behavioral equation as a function in GDP (factor cost) and a step dummy to control for the structural and administrative reforms taking place during the second half of FY 2018/19 and beyond.

3. **Inflation Forecasts: Headline and Core**
   - based on a behavioral equation as a function in GDP (factor cost), induced real money gaps and unemployment rate (Philips Curve).

4. **Exchange Rate Forecasts:**

- Baseline scenario is based on an ARIMA model (1,0,1). While both optimistic and pessimistic scenarios are based on a behavioral equation including inflation and GDP Growth rates.