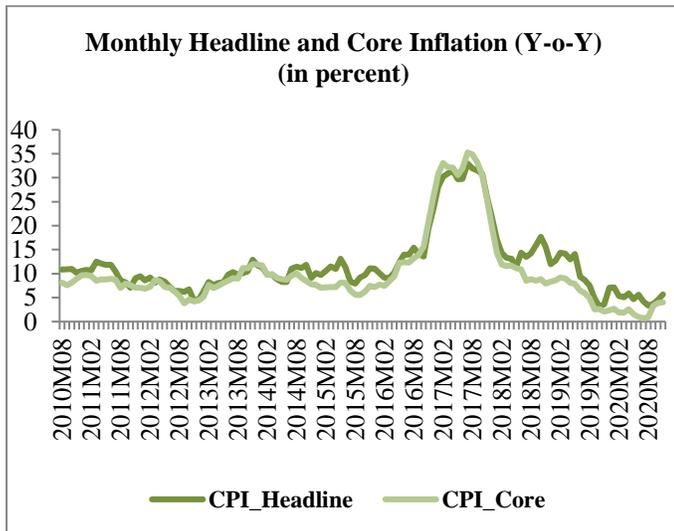


Macro-Note Series "Inflation Note"

Inflation Increased in November on the Back of Accelerated Cyclical Factors

Recent dynamics in headline and core inflation ...

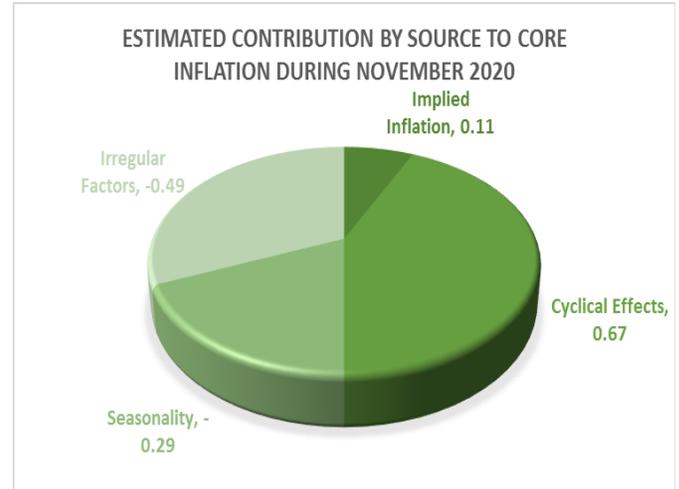
Urban headline inflation (Y-o-Y) inched up to 5.7% in November, compared to 4.5% in the previous month. The pick-up continues for a third month in a row; driven by monthly developments by 0.8% in November, compared to negative 0.3% in the corresponding month. Moreover, core inflation (Y-o-Y) remained broadly unchanged to reach 4.0% in November, up from 3.9% a month earlier. This came on the back of a tamed monthly rate of zero% in November, compared to 1.7% a month earlier.



Source: CAPMAS and Central Bank of Egypt.

...Sources of demand-driven inflation ... During November 2020, the decomposed series shows that the main source which fuels inflation during this month is mainly attributed to cyclical effects for the second month in a row, standing at 0.7 percentage points. This came on the back of the spillovers of the easing monetary stance which took place during 2020, amounting for 400 basis

through mega projects. Such a stance provides a suitable environment for the economy to be promoted, especially in the light of the second wave of COVID-19. Moreover, the inflation expectations retreated -albeit showing a positive contribution of 0.1 percentage points. Nevertheless, both seasonality and external pressures have an offsetting effect on inflation this month, collectively contributed by negative 0.8 percentage points. One explanation can be attributed to a stable FOREX market which is mirrored on decelerating effect from the pass-through effect.



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

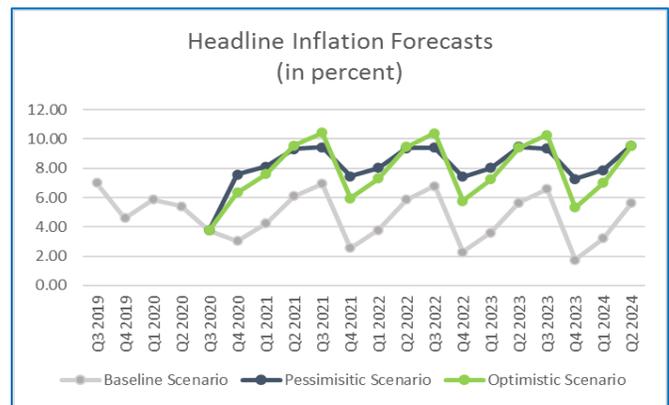
to the baseline scenario which is calculated using univariate ARIMA model specification. Both optimistic and pessimistic scenarios are induced from a macro-model estimation (refer to the technical annex), wherein the estimation period spans from 1Q 2004/05 through 3Q 2019/20.

Headline and core inflation forecasts for FY2020/21...we updated our forecasts upwards, in light of the released statistics and 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 6.1% and 7.2% for FY2020/21. Further, according to the pessimistic scenario forecasts, inflation will pick up -though below the historical average- to hover around 7.6% - 9.3%. The single digit inflation is driven primarily from the macro-economic dynamics concerning expectations of lower GDP growth accompanied by higher unemployment rate. 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 around the target set by the CBE which is 9% (+/-3%) suggesting that the CBE will be able to meet its target by 4Q 2020 and beyond.

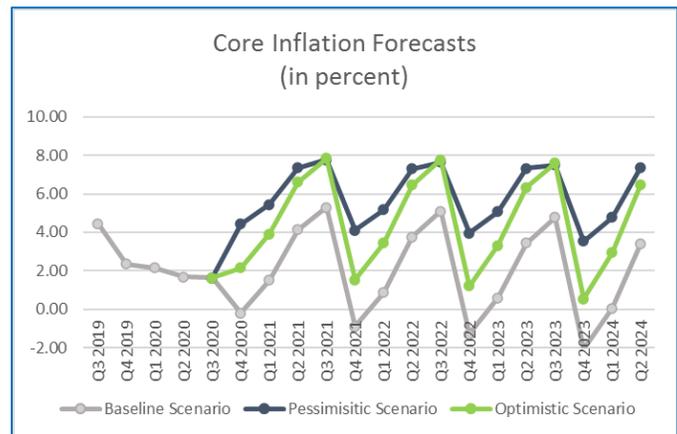
When shifting to core inflation forecasts, recent dynamics indicate that it will be kept well below its historical average of 8.8% for some time. Evidently, we found that it will show a slight pick-up by Q4 FY2020/21, to reach a maximum of 7.4% as per the pessimistic scenario; nevertheless, it will be 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 3.3% on average during FY2020/21.

Worth noting, the baseline scenario is well below the period average for both headline and core inflation, which is consistent with the current situation of

diminished demand (internal trigger) and the relative stability in the FOREX market (external trigger). In addition to the expectations of having a second wave for the pandemic. These dynamics have favorable impact on demand-driven inflation, due to contained demand, pass-through effects and random (irregular causes). 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				
	Pessimistic	Optimistic	Baseline_ARIMA	Average All Scenarios
Q1 2020/21	3.76	3.76	3.76	
Q2 2020/21	7.58	6.35	5.56	6.50
Q3 2020/21	8.12	7.61	7.25	7.66
Q4 2020/21	9.32	9.56	7.80	8.89
Avg. FY	7.20	6.82	6.09	
Core Forecasts				
Q1 2020/21	1.62	1.62	1.62	
Q2 2020/21	4.43	2.15	3.96	3.51
Q3 2020/21	5.44	3.92	3.64	4.33
Q4 2020/21	7.35	6.62	3.81	5.93
Avg. FY	4.71	3.57	3.26	

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.