

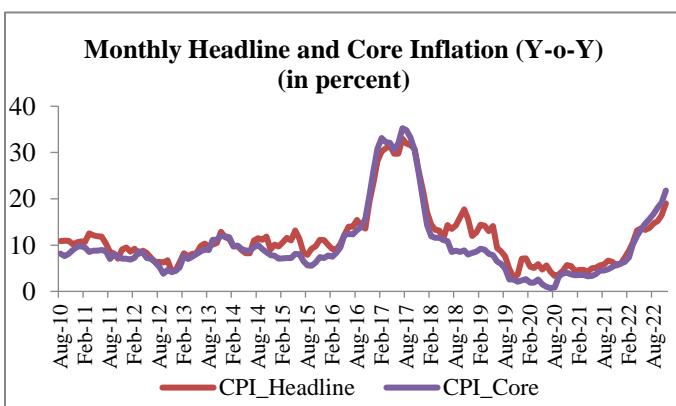


Inflation Expectations and Pass-through Effect are Two Alarming Signs in November

Thursday 8th of December 2022

Recent dynamics in headline and core inflation

... Urban headline inflation (Y-o-Y) increased in November to 18.7% up from 16.2% a month earlier. The current acceleration is a continuous increase for five months in a row. Meanwhile, rapid core inflation continues on its upward trend to register a double digit since last March to reach 21.5% in November compared to 19.0% a month earlier. This has been accompanied by a monthly rate of 2.7% in November, compared to 3.0% a month earlier.

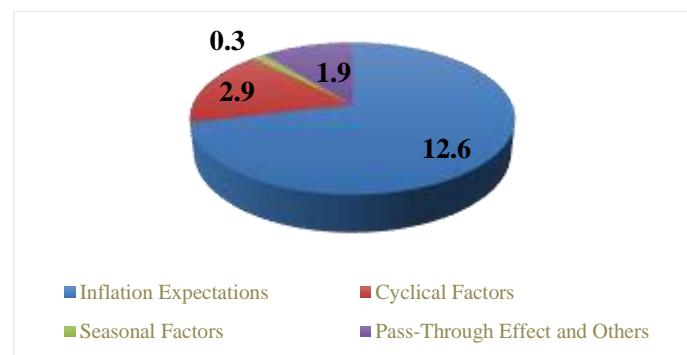


Source: CAPMAS and Central Bank of Egypt.

...Impact of Devaluation on Core Inflation ... The devaluation decision taken on two steps since last March. When the CBE decided to adopt a gradual devaluation step that was followed by the free-flotation decision on October 27th has some unfavorable implications on inflation in general and on demand-driven or core inflation in particular. The pass-through effect has been manifested estimated at 2.9 percentage points out of 17.7% accumulated core inflation during the period March-November 2022, representing about 10% of core inflation. Also, the continuous build-up in Y-o-Y inflation since June 2021, has been accompanied by growing inflation expectations that has been doubled

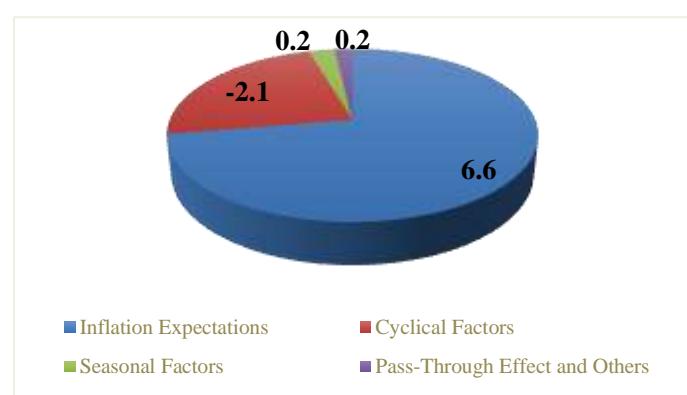
between 2021 and 2022 to record 12.6 percentage points (out of 17.7% as core in 2022), compared to 6.6 percentage points (out of 4.9% as core in 2021). Such dynamics, shed lot of alarming signs for the policymakers at the Central Bank, wherein, prudent measures have to be taken immediately to curb expected inflationary pressures for the rapid-paced depreciating EGP.

Core Inflation Structure for the Period Mar-Nov 2022



Source: MAP's Estimates, MPED and CBE.

Core Inflation Structure for the Period Mar-Nov 2021



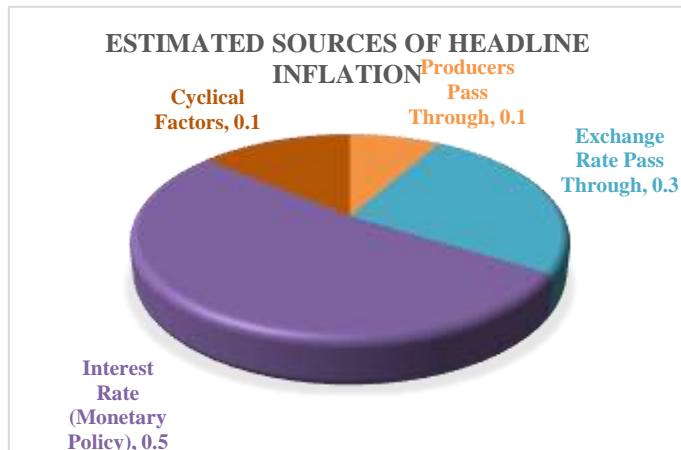
Source: MAP's Estimates, MPED and CBE.

Some Findings and Facts about Headline and Core Inflation... According to an estimated function for the determinants or sources of headline inflation in Egypt, a behavioral equation is estimated to see the magnitude of each variable that is said to have an impact on inflation dynamics over the past 14 years.

Estimated equation shows that all variables are statistically significant and with the expected right signs. The highest impact comes from interest rates with a magnitude of negative 7.2, This finding is twofold: it mirrors the role of the CBE in curbing inflationary pressures, also it reflects how effective are interest rates on inflation “As an Effective Transmission Mechanism Channel in Egypt”

Interest rates are followed by exchange rate (proxied by NEER) with an estimated coefficient of negative 3.5, demand-pull inflation that resulted from the real growth rate and improved purchasing power is quantified at 1.9 and finally the supply-push inflation that stemmed from the producers’ pass-through effect is measured to be 1.1.

The estimated coefficients are then transformed to contributions to headline inflation rate. It has been found that about 50% of the dynamics in the inflation rate comes from the monetary policy decisions, implying more effective role of the CBE in affecting the inflation rate during recent years, this is followed by the exchange rate pass-through effect quantified at 30% of the inflation rate dynamics. Finally comes both the producers’ pass-through effect (supply-push) and cyclical factors (demand-pull) inflation each contributes by 10% of the overall inflation dynamics.



Source: MAP's Estimates, MPED and CBE.

In analyzing the anatomy of core inflation in terms of the actual materialization of pass-through effect after the CBE recent steps of devaluation in March 2022 and the final decision of free-floated FOREX in October 2022, it has been found that:

- 1- The impact of exchange rate on inflation is more evident on core relative to headline,
- 2- The first policy shock to the FOREX market in March has a more prominent and immediate effect on core inflation calculated at 51% (1.59 percentage points out of 3.1% monthly core rate),
- 3- The free-float decision has a more tamed effect on core and with a lag effect of one month rather than being immediate estimated at 20% (0.55 percentage points out of 2.7%)
- 4- The average impact on inflation from the two decisions is estimated at 36% which represent the evident pass-through effect from exchange rate to core inflation, which is well above the one estimated for headline at 30% as presented earlier in the note.

Against all the previous background, these findings motivate the belief that interest rate movements are essential at this juncture so that raising policy rates now can send important signals about having more prudent and accommodative monetary policy to the market, to mitigate the devaluation repercussions and anchor the growing inflation expectations.

This is true to a great extent, but we should not ignore the real sector objectives of economic growth and employment absorption, knowing that the private sector operational conditions -proxied by the Purchasing Managers' Index (PMI)- are currently in an unfavorable status in five years.

Thus, the appropriate policy mix is to achieve the inflation objective while unaltered the lending conditions for the leading sectors of growth primarily manufacturing, agriculture, and wholesale & retail sales. Also, investment should

be encouraged for those sectors which are characterized by the crowding-in effect such as the construction and extractions sectors by enlarging the role of the private sector and engaging more the private businesses.

Therefore, there is now an urgent call for the adequate coordination between the real sector embodied in the Ministry of Planning and Economic Development (MPED), the monetary policy represented in the Central Bank of Egypt (CBE), and the fiscal policy represented by the Ministry of Finance (MOF), to come up with the appropriate policy mix that would not lead to economic disruptions in light of the current exceptional economic conditions.