



Egypt

Inflation: EGP depreciation does not explain everything

The floatation of the Egyptian pound since November 2016 and the introduction of fiscal reforms have significantly improved the macroeconomic situation, in particular forex reserves. The sharp EGP depreciation has pushed inflation to 30-year high, highlighting the sensitivity of consumer prices to currency fluctuations. However, other factors have also had a key role such as strong corporate pricing power in the consumer goods sector, particularly due to supply chain inefficiencies. Fiscal policy is also contributing to rising prices, but to a more limited extent. Getting inflation down could take some time, and in the short term, the authorities have limited resources to tackle it.

The economic situation in Egypt has improved significantly since the Egyptian pound was allowed to float in November 2016. To no great surprise, the most significant improvement has come in external accounts and foreign currency liquidity. Currency reserves at the Central Bank of Egypt (CBE) have increased by 60%, reaching USD 31.3 billion in June 2017, equivalent to nearly six month cover of goods and services imports. The credibility of the new exchange rate regime and substantial increase in yields on government securities have attracted more than USD 10 billion in foreign portfolio investment as of July 2017, compared to virtually zero up until mid-2016. It should be noted that this figure, relating to carry-trades, is not included in official currency reserves as it is based on inflows prudently considered by the CBE as volatile. The improvement in public finances has been lower, but the trend is positive for the moment. The gradual reduction in energy subsidies and the increase in certain fiscal receipts (VAT) should help reduce the primary budget deficit for the fiscal year (FY) 2016/17 by more than half (to 1.9% vs estimated 4.5% of GDP in FY 2015/16). However, the debt servicing cost remains very high, at more than 8% of GDP, or around 45% of total fiscal receipts, meaning that the overall budget deficit will remain above 10% of GDP in FY 2016/17.

Economic activity is showing signs of vigour, but that remains to be confirmed. Household consumption, one of the main drivers of economic activity, is severely constrained by rising prices. Annual consumer price inflation has been running at an average of over 30% since January. This rate of inflation is partly due to the sharp EGP depreciation since November 2016 (-50% against the USD). However, we believe that other elements are important explanatory factors in Egypt's structurally high inflation and the magnitude of price rises over the last six months.

■ Currency movement is crucial

There is significant exchange rate pass-through to inflation. Analysis of the period from 2003 to 2015 by faculty members of Cairo University and the CBE¹ showed that relatively little of this happens through a direct effect on the price of imported goods; more significant transmission occurs through an indirect effect via the increase in the prices of semi-finished goods and commodities, which feeds through into production prices and then consumer prices. This mechanism is particularly due to existence of few sizeable domestic manufacturers across consumer goods segments. According to the authors, this transmission is not immediate, and persists over a two-year period. Moreover, the level of transmission

¹ Omneia Helmy, Mona Fayed, Kholoud Hussein, 2017, *Exchange rate Pass-through to Inflation in Egypt: A Structural VAR Approach*, 37th Annual meeting of the Middle East Economic Association.

1- Forecasts

	2015	2016e	2017e	2018e
Real GDP growth (%)	4.1	4.3	3.8	4.5
Inflation (CPI, year average, %)	11.5	10.2	23.7	24.8
Gen. Gov. balance / GDP (%)	-11.4	-12.7	-11.5	-10.7
Gen. Gov. debt / GDP (%)	88.0	97.0	94.0	82.0
Current account balance / GDP (%)	-3.7	-5.6	-2.9	-2.5
External debt / GDP (%)	17.0	18.0	32.0	30.0
Forex reserves (USD bn)	20	18	31	40
Forex reserves, in months of imports	3.1	2.9	5.7	6.8
Exchange rate EGP/USD (year end)	7.4	8.8	18.1	16.5

(*) Fiscal years T-1/T (July-June)

e: BNP Paribas Group Economic Research estimates and forecasts

2- CBE forex reserves



Sources: CBE, BNP Paribas

is considered as incomplete, due to the existence of numerous goods for which prices are controlled.

From November 2016, the increase in consumer prices has been incremental rather than immediate, but it has been substantial. The scale of the EGP depreciation is clearly a decisive factor. After the pound was allowed to float in 2003, its depreciation relative to the USD was fairly modest (13% after one year, and 25% after twenty months), whereas it immediately fell 50% following the decision to let it float in November 2016.

In addition, the level of transmission has varied since 2003 due to more structural factors. The share of imports in GDP is currently



much higher at 21% compared to 14% in 2003 in real terms. We can also assume that over the medium term this figure will be higher, given the tight restrictions on the availability of foreign currencies that hampered importers over the quarters preceding the EGP liberalisation in November 2016.

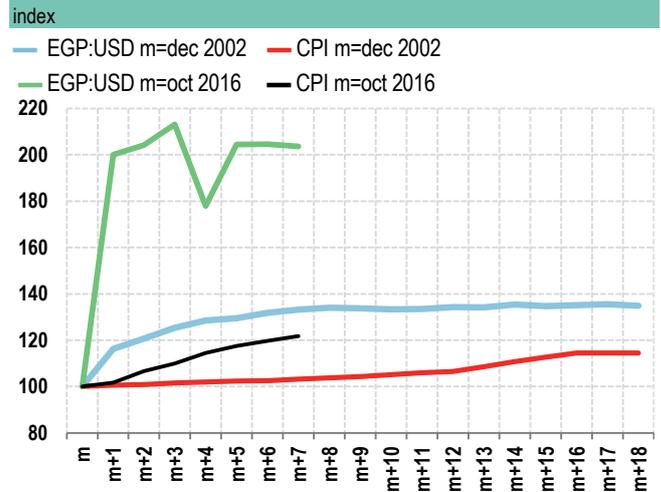
Another factor affecting the degree of transmission is the reaction of companies to the currency depreciation. Schematically, faced with higher import costs they need to choose between maintaining their margins or their market share. One determiner of this choice can be the scale of any depreciation. A modest change would be easier to absorb in terms of costs, and the depreciation in March 2016, of around 13%, did not result in a significant rise in inflation. After the depreciation in November 2016, on top of the increase in prices for imported factors of production, most private corporates in the formal sector raised wages (by 10-20%), making an increase in selling prices necessary. Another more structural factor influencing inflation relates to market organisation, and specifically the level of competition in the consumer goods sector.

■ Limited competition in the consumer retail market

We believe that limited competition in the consumer goods market, and specifically food retail, is a major driver of inflation. Food is a crucial item as it represents circa 34% of average household expenditure as well as 31% of the inflation basket (excluding seasonally-fluctuating fruits and vegetables). It appears that control over distribution channels (up to and including a certain level of integration) is a key determining factor for producers in setting their pricing strategies. Companies may have direct control over part of their distribution channels and/or be mainly distributing through traditional circuits (local shops) in which they have higher control over selling prices. The modern retail sector (e.g. hypermarkets) sector is expanding rapidly as demonstrated by recent entry of major regional supermarkets to Egypt². However producers tend to favour traditional distribution channels. Their products are present in supermarkets, but there is a real desire to limit the share that this represents, in order to protect pricing power. This strategy is made possible due to relatively low competition in the domestic market. According to the latest World Economic Forum report on global competitiveness, Egypt ranks 112th (out of 138) in terms of the efficiency of the market for goods and 127th on the "intensity of domestic competition" sub-component. In a certain number of markets for consumer goods, particularly food, local producers hold the bulk of market share and the role of multinationals remains fairly marginal. Following the EGP depreciation there is anecdotal evidence that some price hikes in certain consumer good categories may have gone beyond covering the rising cost of intermediate imported goods allowing producers to make up lost ground after several years of relative price stability. Limited competition in the consumer retail market may also explain the persistence of high inflation over a long period, even when production capacity is not fully utilised. The expansion of modern supermarkets in Egypt may therefore promote competition and relieve inflation, but also threaten producer margins.

² In 2013-2016, leading MENA supermarket groups entered Egypt such as Lulu, Panda, Al Othaim and BIM in addition to expansion of existing foreign players such as Carrefour and Spinney's.

3- EGP floatation and CPI inflation: 2003 and 2016



Sources: CBE, BNP Paribas

■ Fiscal policy

In H2 2016, the reduction in energy subsidies was another important factor of consumer inflation. Petrol prices were more than 100% higher than in 2014, whilst increases in electricity prices ranged from 29% to 124% depending on the consumption tier. The monetisation of the budget deficit, by expanding the money supply, may be inflationary, but this factor does not appear decisive. This monetisation was fairly substantial in 2015 but was reduced in 2016. In more general terms, we are not seeing an uncontrolled expansion of money supply. The M2 aggregate as a percentage of GDP rose only slightly – from 76% to 80% – between late 2014 and March 2017.

In the short term, consumer price inflation is likely to remain elevated. CPI inflation reached 23.7% in FY2016/17 and almost 25% is expected in FY2017/18. Further subsidy cuts, the persistence of imported inflation and a possible upturn in domestic demand are all likely to continue driving inflation. Higher energy and farm product prices on international markets should also be considered, although oil price recovery is likely to be subdued in the medium term. The resources available to the government and the CBE to tackle inflation are currently limited. The effectiveness of the interest rate lever is limited by the low adult bankability ratio (less than 15%), whilst, up to now, the CBE's exchange rate policy focuses building up currency reserves in order to protect against possible tensions. The recent EGP appreciation could signal a change in this policy.

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