Egypt, Inflation and an Increasingly Restive Population

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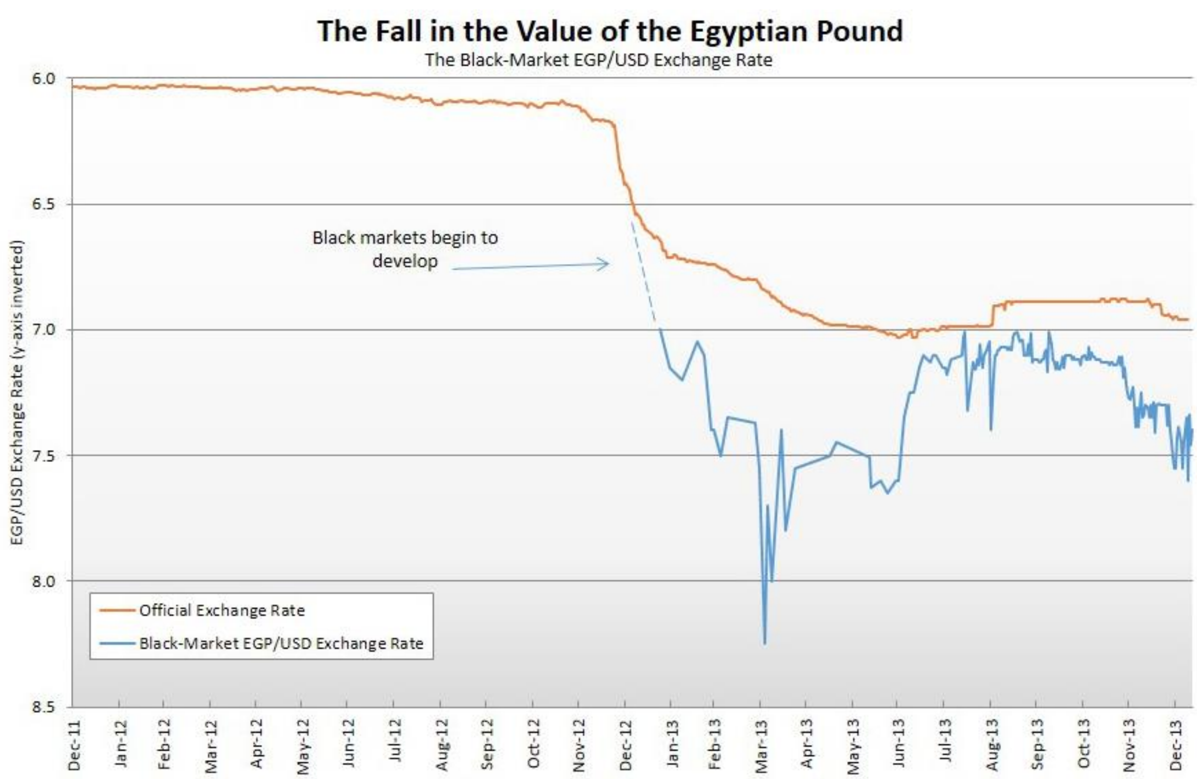
A joint Cato Institute - Johns Hopkins project by Professor Steve Hanke, the Troubled Currencies Project, examines the role of conflict, economic sanctions and political mismanagement on five of the world's currencies, that of Argentina, Egypt, North Korea, Syria and Venezuela. The issues facing these five nations have resulted in higher rates of inflation, often much higher than officially reported inflation rates that are used to placate the local population. To address this inaccuracy, Professor Hanke collects black market exchange rate data and from that, is able to estimate the implied or real world inflation rate that the local civilian population experiences. In this posting, I will look at his research on Egypt, a subject that is of particular interest now that Egypt has passed the third anniversary of its 2011 uprising.

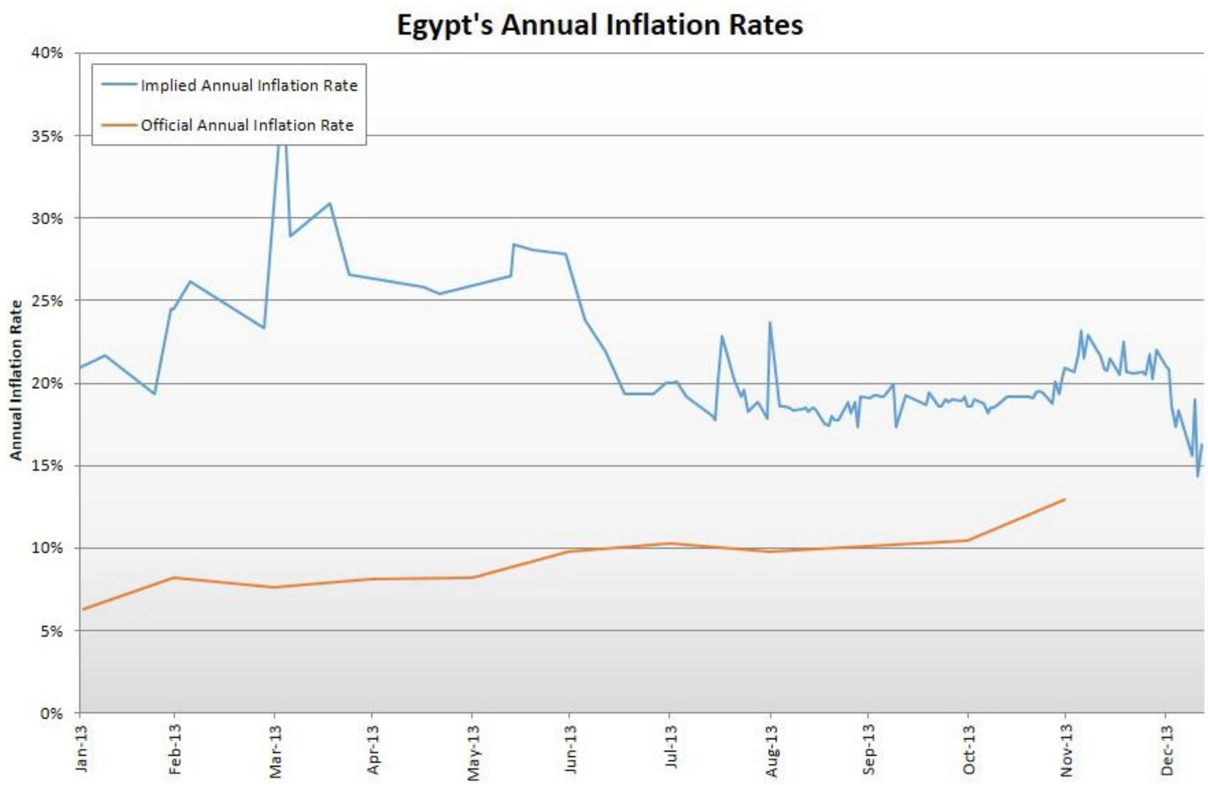
Here is a graph showing the fall in the value of the Egyptian pound since December 2011:



As shown on the orange line, in December 2011, the official exchange rate was just over 6 Egyptian pounds to 1 United States dollar. In late 2012, the value of the pound began to drop, hitting a low of 7 pounds to the dollar by May 2013 the rising slightly to 6.9 pounds to the U.S. dollar and falling back to its current level of 6.96 pounds to the U.S. dollar.

You will notice that the real world exchange rate is substantially different than the black market exchange rate as shown on the blue line. Egypt's currency black market began to develop in late 2012; by March 2013, the black market exchange rate had fallen to 8.25 pounds to the U.S. dollar. By mid-2013, the official exchange rate was relatively close to the official exchange rate with a difference of roughly one quarter of a pound. Since October 2013, the black market exchange rate has dropped to roughly 7.5 pounds to the U.S. dollar and the spread between the official rate and the black market rate has widened to half a pound.

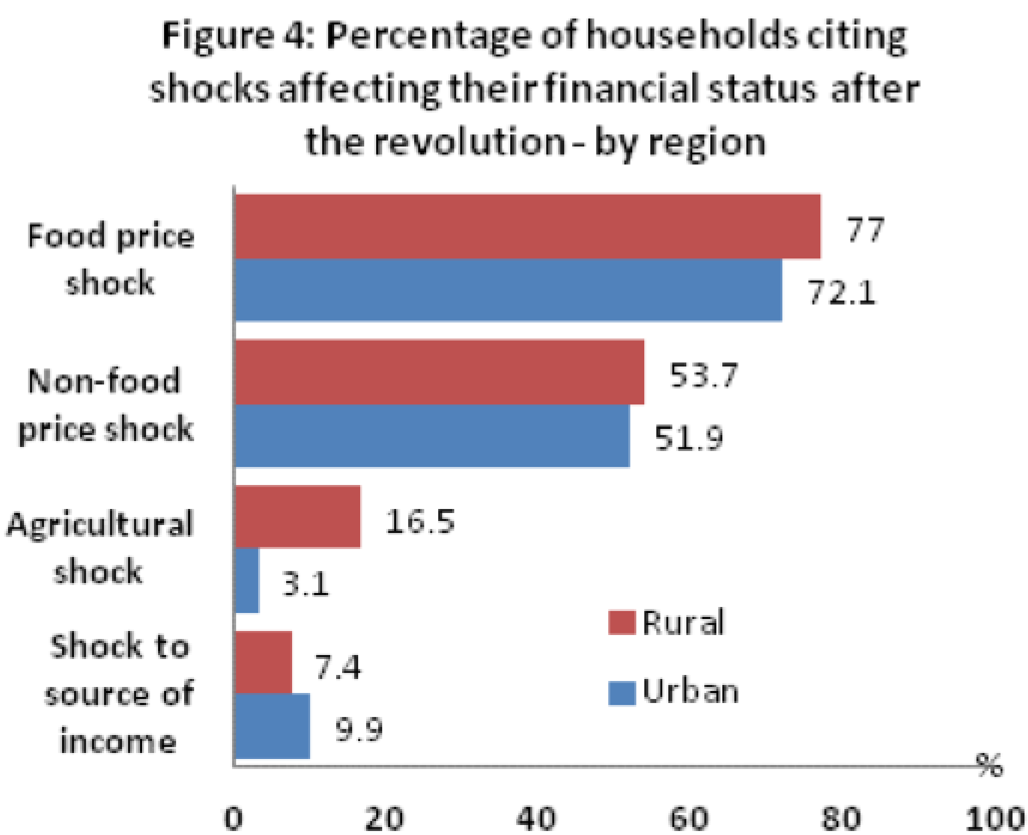
Here is a graph showing Egypt's official inflation rate and its implied inflation rate, calculated by Professor Hanke using the black market exchange rate data:



Over the period from January 2013 to December 2013, the official inflation rate rose from 6 percent to a high of 12.97 percent in November 2013. In contrast, as shown on the blue line, the implied inflation rate hit a high of 35 percent in March 2013, dropping back to its current level of between 15 and 20 percent, still very high by Western standards. For most of the year, the inflation rate has been at or above 19 percent.

The Central Bank of Egypt reports that headline inflation in December 2013 was 11.66 percent with core inflation at 11.91 percent (core inflation strips out subsidized goods and volatile items including fruits and vegetables). Headline inflation dropped from 12.97 percent in November and core inflation dropped very slightly from 11.95 percent in November. In contrast to most central banks, despite elevated levels of inflation, since President Mubarak was deposed in July 2013, the Central Bank of Egypt has cut its discount interest rates three times by a total of 150 basis points to its current level of 8.75 percent, stating that it was more concerned about boosting economic growth than it was about battling inflation. What is of some concern is that the year-over-year price index for fruits and vegetables rose by 28.3 percent in November 2013 and 20.5 percent in December 2013. This could prove to be problematic for the new military government since there are likely to be social repercussions if inflation for necessities continues to run at these high levels, a scenario that is increasingly likely now that the Central Bank of Egypt has lowered interest rates. Additionally, the Egyptian economic growth level has fallen to 1.04 percent in 2013/2014 Q1 from an already "feeble growth rate" of 2.1 percent recorded in 2012/2013. That is also unlikely to make a restive population happy.

From what we can see, it certainly appears that Egypt's new military junta has its work cut out for it when it comes to keeping Egypt's civilian population happy. Should the Central Bank of Egypt's interest-rate cutting program backfire, it may not just be very uncomfortable levels of inflation that are reignited. As shown on this graph, a very high percentage of Egyptian households experienced food price shocks after the revolution, a situation that has led to household rationing and dietary changes:



With an average Egyptian family spending 40.6 percent of their income on food and 48.9 percent of the population living below or just slightly above the poverty line, the potential shock of higher food prices could prove critical to a peaceful resolution of the current crisis.