# Flash Comment #102

April 28, 2016

## Egypt: adjustment in currency management and exchange rate combined with external financial support to reduce short-term risks

*The substantial financial support received by Egypt from both the GCC and multilateral agencies, associated to a more flexible exchange rate policy and the pick-up in energy prices are enough to reduce the overall degree of country risk for Egypt over the short-term. The Egyptian Pound is likely to depreciate further, but in more gradual steps and not on a large scale.*

*Over the longer-term, the very tense underlying political and social situation associated with worrying fiscal development to suggest much higher long-term risks, particularly on the sovereign.*

The visit of Saudi Arabia King Salman to Egypt earlier in April and the large number of projects and funding that were announced over the past few days or weeks (from industrial parks to a bridge over the Red Sea…) were a clear reminder of Egypt's challenges and current dependence on external support to support a direly needed acceleration in economic growth.

Nevertheless, this large financial support is combining with a change in economic policy to suggest better economic and financial performances ahead, notwithstanding the persistent underlying tensions and vulnerability.

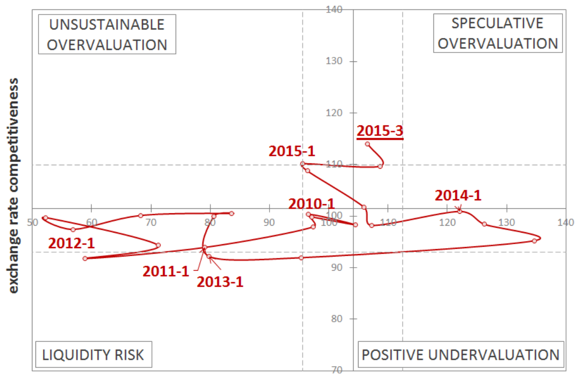
### Recent and welcome change in Egypt's exchange rate policy

The acute tensions on international liquidity and the acceleration in inflation that were associated with the political turbulences in 2011-14 "forced" the authorities to engineer a cycle of gradual devaluations, pushing the exchange rate of the Egyptian Pound (EGP) from EGP 6.0 against the USD in mid-2012 to EGP 7.8 in 2015Q3.

However, starting in 2014, such adjustments were "behind" competitiveness requirement and inflation; they were substituted by increasing constraints on importers and difficulties in accessing foreign currency for domestic corporates. At the end of 2014, Egypt's path on our Foreign Exchange Balance moved above the neutral threshold, at a time when the international environment (flat global trade and low oil prices, weighing on the revenues from the Suez Canal and energy exports …) as well as domestic / regional tensions worsened substantially.

The change in monetary and exchange rate policies decided since the nomination of the new Egypt's central bank governor are therefore a welcome adjustment to a more dangerous development. The recent devaluation has probably brought back our *foreign exchange competitiveness* index (vertical axis on the chart above) close to the neutral threshold; in a context of persistent inflation and large external deficits, a more flexible exchange rate policy and a more "neutral" position today suggest however that the currency is likely to continue a modest depreciation trend over the next 18 months.

**Foreign Exchange Balance**




Source: TAC ECONOMICS

### Background five years after the Arab Spring

Back in 2004, Egyptian authorities started to engineer a shift in economic policy (already an important change in currency policy, structural reforms in taxation and financial sector, privatization ...) that allowed an indisputable improvement on growth and external accounts, but always with fiscal fragility and substantial inflation.

The global crisis of 2008/09 had a substantial negative impact on the country's overall performance, notwithstanding the ability to avoid a recession through fiscal and monetary measures to support domestic demand. The break-out of the "Arab Spring" occurred therefore in a context of greater macroeconomic fragility and lack of fiscal space, all in a context of increasing corruption and weakening social cohesion.

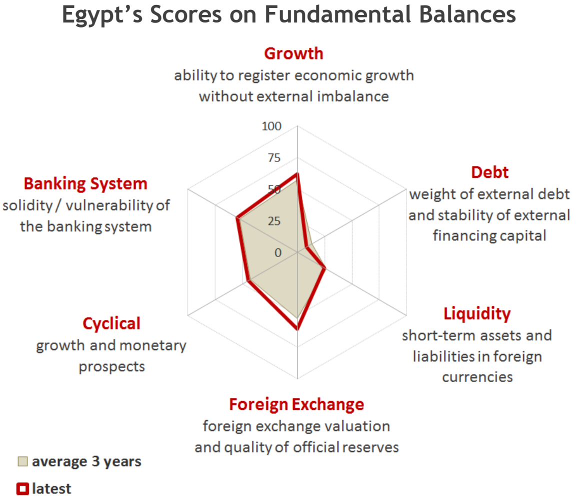
After a period of complex and violent "transition" that ultimately resulted in the elimination of the Muslim Brotherhood as a major force in post-Mubarak Egypt and the emergence of a strong authoritarian regime, the election of President Sissi in May 2014 initiated relative political stabilization, concomitant with massive financial support from the GCC countries and a restart of economic activities that had been partially paralyzed since 2011. Economic growth has accelerated, but the negative international context and persistence of acute security problems limit both the depth and duration of this recovery, while external and fiscal accounts remain a concern.

### Current risk situation

The Egyptian economic and financial performances measured through our six Fundamental Balances paradoxically reveals a fairly low level of aggregate Economic & Financial Risk (average rating at 39.2-B), a significant reduction from the highs of 2012-2013 and no early warning signal of a systemic shock.

This result is mainly due to the very favorable score registered for our Debt Balance, which looks at the long-term funding of the country in foreign currency: indeed, the combination of low aggregate fx debt service and a rebound in foreign direct investment (FDI) explain the positive reading and hence a better than expected risk rating. Statistics show that total debt in foreign currency, at around USD 40 bn, amounts to a low 55% of the country's total revenues in foreign currencies; in parallel, FDI have rebounded from zero or even negative figures in 2011 to a decent USD 5bn during the last two years.

From an analytical point of view, the quality of this Debt Balance basically reflects the financial support from the GCC countries, through transfers or FDI: such support is ultimately a sort of guarantee on the external finances of the country.




The Cyclical Balance remains "average", with a neutral monetary policy accompanying a relative decline in demand, in a context of a large aggregate domestic financial leverage that also weighs down on the Banking System Balance.

But the weakest Balances for Egypt are clearly for Growth and Foreign Exchange: the first confirms the structural constraints facing the country's long-term development, and partly explains the sharp deterioration of the degree of risk for our longer horizon (45.7 for the Activity Rating on the 3-5 years horizon, against 37.9 for the less-than-one-year horizon). The poor score of the Foreign Exchange Balance should improve after the change in currency policy.

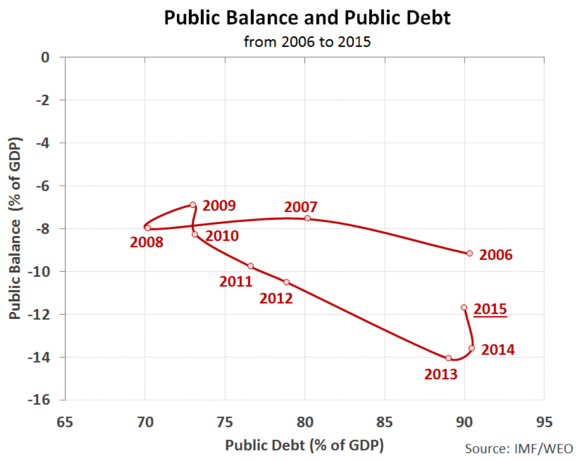
These two "core weaknesses" make the management of the country's international liquidity very difficult: notwithstanding a very low level of short-term liabilities in foreign currency, the level of reserves held at the central bank (fx reserves were USD 13.3 bn at the end of December 2015, below three months of imports) highlights again the dependence to financial flows and support from GCC countries.

The overall risk situation of Egypt is therefore ambivalent: the adjustment in economic policy and the greater exchange rate flexibility should allow a "favorable" adjustment while support from donors (GCC, multilateral and official bilateral institutions) remains substantial. External accounts should gradually improve, while activity would remain correct albeit insufficient.

### Budget and political issues critical for long-term risks

The combination of a tough authoritarian control and strong external financial support are the core factors behind the seemingly more stable political situation in Egypt. The intensity of media control and the worries expressed by the authorities regarding any form of political opposition are the clearest signs of the deep underlying tensions, whether purely political (support for the Muslim Brotherhood, ambivalent positioning of fundamentalist parties) or social (very high unemployment, inflation). The fragile political situation has large consequences on the ability to adjust budget spending and revenues in order to ensure longer-term stability.

Room to manoeuver are however narrow. The country shows both a high level of total public debt (90% of GDP) and a large fiscal deficit (-11.7% of GDP estimated by the IMF for 2015).




Overall, exposure to the sovereign over a longer horizon appears to be fraught with much larger risk that the aggregate country risk. Forms of, and conditions attached to, GCC support will therefore be the most direct element for risk materialization in Egypt over the short- to medium-term.