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Economics

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EGP Update

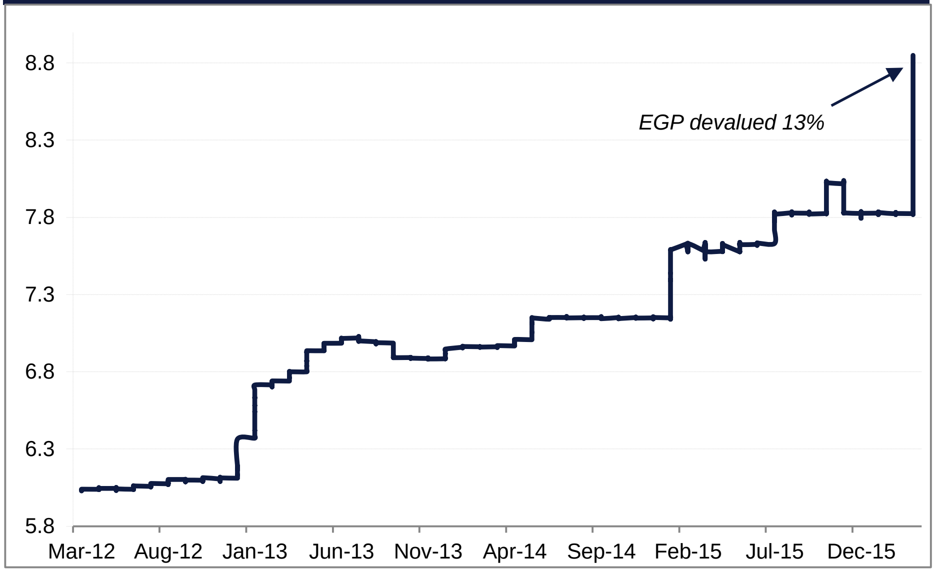
The Egyptian pound was devalued by nearly 13% at an exceptional FX auction on 14 March, with the Central Bank of Egypt selling USD198mn to local banks at a rate of 8.85. Anticipation of a possible devaluation had been steadily building in recent weeks, as authorities introduced several new policies (*see below*) which appeared to be aimed at increasing FX liquidity and clearing a backlog of imports ahead of the move. Indeed, an exceptional FX auction was held just last week on 6 March, at which the CBE sold USD500mn at the previous official rate of 7.73.

One crucial question following the devaluation already appears to have been answered, with the CBE announcing that rather than simply re-pegging the currency at a lower rate, it was now going to move to a more flexible exchange rate regime, with '*levels that reflect the strength and real value of the local currency in a short period of time*'. This marks a significant departure from previous policies which were effectively *de facto* USD pegs, or tightly managed crawling pegs. Given Egypt's still weak balance of payments position, **from a fundamental macro perspective this means that further depreciation for the EGP is a distinct possibility**. In the near term additional depreciation towards 9.25 cannot be ruled out, implying roughly 5% in additional losses. A key challenge for the CBE will now likely involve showing the market that the devaluation was a one-off aimed at correcting previous imbalances, while any further moves will be a reflection of fundamentals.

Since the start of 2014 the EGP has weakened only 11% against the USD, compared to losses of 17% and 19% for the Moroccan dirham (MAD) and Tunisian dinar (TND) respectively. In contrast, the currency has appreciated 12% against the Euro, compared to only 4% and 1% for the MAD and TND. In the context of the broader emerging market FX selloff that has been seen in recent years, in which many major EM currencies have depreciated over 25% against the dollar, the EGP's relative stability stands out. Given high domestic inflation during this time period, the pound's real effective exchange rate has been steadily climbing, which has led to a gradual erosion in competitiveness.

In this sense, the devaluation is undoubtedly a positive development, and should help set the stage for a recovery first in foreign capital inflows, and eventually a broader economic recovery. Indeed, defending an exchange rate that is widely perceived to be overvalued not only drains FX reserves and undermines the export sector, but also acts as a deterrent to foreign investment, which in turns weakens the economic outlook (thus becoming a self-perpetuating problem).

Egyptian Pound



Source: Bloomberg, Emirates NBD Research

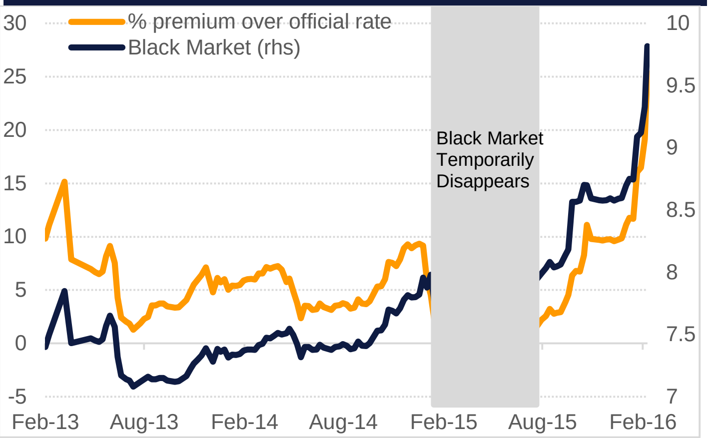
Late last week an unnamed official at the CBE was reported as saying that the bank was set to launch a new options product that would allow foreigners to invest in the local t-bill market while hedging against currency risk (more details of this program should be released in the coming days). As an indication of foreign portfolio investors' concerns, as of November these customers held only EGP371mn in Egyptian t-bills, accounting for 0.1% of total holdings, compared to 21.1% in December 2010. Assuming there is now a greater degree of confidence that the worst of EGP depreciation is behind us, **this devaluation could finally mark the beginning of the return of short-term foreign portfolio investors**, which in itself can go some way towards strengthening the underlying balance of payments position.

There have been several other efforts introduced in recent weeks aimed at attracting external capital. First, in late February the CBE introduced new USD certificates aimed at expats. Known as 'Biladi', they are being offered by three state-owned banks, and range in tenor from one to five years. Remittances are by far the largest source of FX for Egypt at the moment, and there is a risk that slowing non-oil growth in the GCC will result in a drop in inflows this year. Latest data we have is for July-September (FYQ1), and shows the total value of remittances dropping 9% y/y. Our previous research has shown a strong correlation between changes in oil prices and remittance inflows into Egypt, suggesting that further declines in the latter are possible in the months ahead. With tourism revenues also having fallen significantly since last November, tapping into this source of foreign capital will also be increasingly critical.

The devaluation also comes shortly after the CBE lifted its cap on FX deposits and withdrawals for individuals and importers of essential goods. The previous limits had been in place since last year, and were effectively an attempt at eliminating the EGP black market exchange rate. However, as the black market has continued to thrive (the currency was last reported by Bloomberg to be trading at 9.684), and with local firms increasingly being forced to curtail output due to FX shortages, authorities have clearly shifted their priorities towards addressing the issue of FX liquidity. In this sense, the devaluation is also likely to be a precursor towards removing these controls which have largely been blamed for exacerbating the economic downturn. **For Egypt's economic outlook, the removal of any remaining FX controls will be significantly more important than the level at which the EGP eventually settles**.

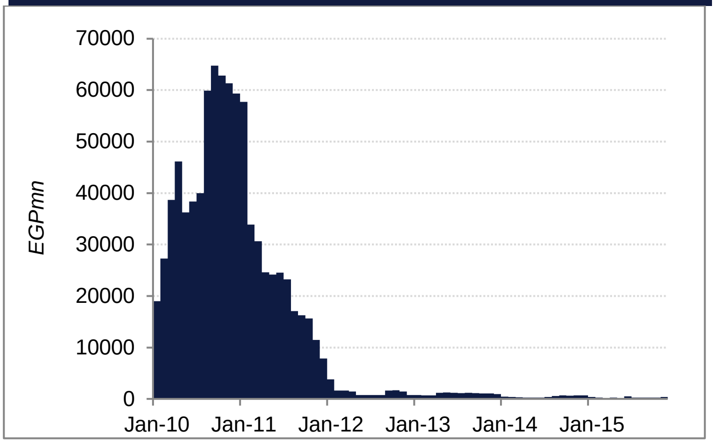
The Central Bank of Egypt's monetary policy committee is set to meet later this week, at which **a hike in interest rates of at least 100bps, but potentially greater is increasingly expected** (the overnight deposit and lending rates are currently 9.25% and 10.25% respectively). Certainly, there is going to be a temporary boost in inflation on the back of the devaluation, and we expect the central bank to make note of the need to help anchor inflationary expectations in this environment. More importantly however, the move away from a *de facto* peg and towards a more flexible exchange rate regime will necessarily involve a greater role for domestic monetary policy. This is particularly the case when an economy is undergoing balance of payments strains such as what is being seen in Egypt currently, and the need to attract and retain capital in the domestic banking system will be increasingly important.

Egyptian Pound



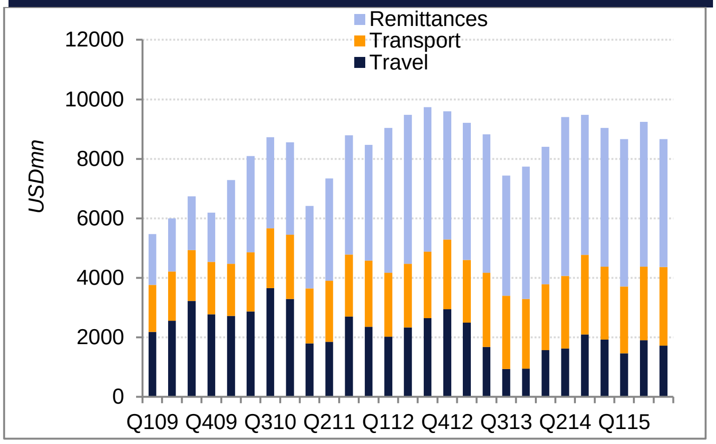
Source: Bloomberg, Emirates NBD Research
Chart #1

Foreign Customer Holdings of T-Bills



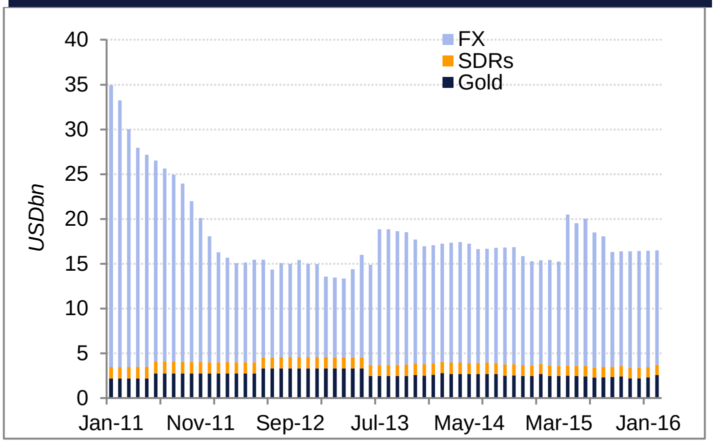
Source: Havers, Emirates NBD Research
Chart #2

Key Sources of FX



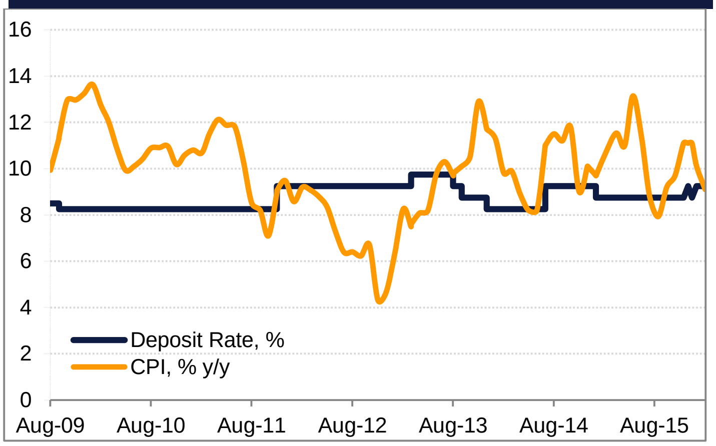
Source: Markit, Emirates NBD Research
Chart #3

FX Reserves



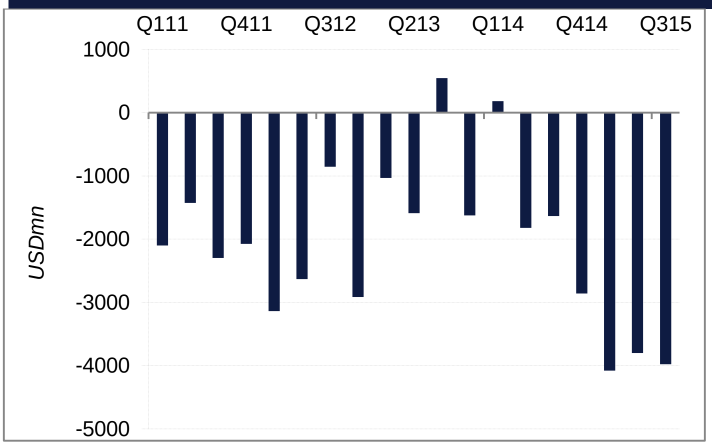
Source: Havers, Emirates NBD Research
Chart #4

Monetary Trends



Source: Bloomberg, Emirates NBD Research
Chart #5

Current Account Balance



Source: Havers, Emirates NBD Research
Chart #6

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