Egypt Watch

Fourth time's a charm

Devaluation and support put Egypt back on right track

The Central Bank of Egypt's (CBE) fourth devaluation of the Egyptian Pound (EGP) since 2022, the front-loaded 600bps hike at an unscheduled meeting and the upsizing of the International Monetary Fund (IMF) program reduce medium-term sovereign credit risks, in our view. The United Arab Emirates (UAE) Foreign Direct Investment (FDI) injection of immediate liquidity is likely to help service the Fx backlog near-term and reduce funding gaps. The risks are a) little EGP flexibility; b) reform slippage; and c) regional geopolitics.

EGP flexibility is key test for markets

We expect a flexible but managed exchange rate regime going forward. The CBE did not explicitly label the Fx regime, beyond that it would be "determined by market forces" in the context of a "transition to a flexible inflation targeting regime". We think authorities are likely to resist a persistent and large overshooting above the 50 level for USD/EGP.

Thanks to favorable base effects, we see headline inflation peaking at 32%yoy over the coming months before gradually coming down, allowing real interest rates to emerge in the summer. Fiscal discipline is paramount as devaluation mechanically pushes central government debt up by 2ppt to 92.5% of GDP over the 6-month period to end-FY24.

IMF program upsizing in line with expectations

Access under the original IMF program has been augmented from US$3bn to US$8bn. It is still unclear if limits on total public investment are binding. Mobilizing further international financing assurances is key. This includes negotiations on further FDI mega-deals and US$12bn in funding from the World Bank and the European Union (EU). The latter likely largely reflects EUR9bn (US$9.8bn) in EU investment pledges.

UAE FDI eases external liquidity position

The UAE effective debt-for-equity swap operation affords policy-makers breathing room for reform. It could boost bilateral debt rollover rates, allow marginal net positive multilateral inflows (excluding the IMF), entice portfolio flows and support CBE Fx reserves build-up. The Fx backlog could be fully cleared through use of the first US$10bn tranche of UAE proceeds, while other tranches meet external gaps over 1-2 years.

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Macro: fourth time's a charm

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Devaluation and support put Egypt back on right track

The Central Bank of Egypt's (CBE) fourth devaluation of the Egyptian Pound (EGP) since 2022, the front-loaded 600bps hike at an unscheduled meeting and the upsizing of the International Monetary Fund (IMF) program by US$5bn to US$8bn reduce medium-term sovereign credit risks, in our view. The United Arab Emirates (UAE) Foreign Direct Investment (FDI) injection of immediate liquidity is likely to help service the Fx backlog near-term. The risks are a) little EGP flexibility; b) reform slippage; and c) regional geopolitics.

EGP flexibility is key test for markets

We expect a flexible but managed exchange rate regime going forward. The CBE did not explicitly label the Fx regime in its statement, beyond that it would be "determined by market forces" in the context of a "transition to a flexible inflation targeting regime". IMF statement highlights however "agreement that a flexible exchange rate regime would help Egypt manage external shocks".

We think authorities are likely to resist a persistent and large overshooting above the 50 level for USD/EGP. We expect the CBE to have agreed with the IMF upon a budget for Fx intervention in the short-term to gradually guide the narrowing of the spread between the parallel and official Fx rates.

UAE FDI eases external liquidity position

We view the UAE FDI as effectively a debt-for-equity swap that potentially helps improve the external liquidity of Egypt, cap EGP depreciation pressures, improve the composition of CBE Fx reserves and the expected return on UAE Fx funds.

The UAE (represented by the Abu Dhabi-based Sovereign Wealth Fund (SWF) Abu Dhabi Developmental Holding Company (ADQ)) and Egypt agreed to a US$35bn FDI deal in February. The deal involves developing the Ras al-Hekma area west of Alexandria on the Mediterranean coast.

ADQ is to acquire the development rights for Ras El-Hekma for US$24bn. ADQ is expected to use its cUS$11bn in deposits (at the CBE) for funding FDI deals. In turn, this would be eventually utilized for investment in projects across Egypt (including Ras Al-Hekma). The Egyptian government is to retain a 35% stake in the Ras El-Hekma development. The project is expected to attract over US$150bn in investments over the duration of its development, according to official statements. Work is expected to start in early 2025.

Authorities announced ADQ would disburse US$15bn within two weeks of the announcement, and the remaining US$20bn over the coming two months (i.e. by mid-April). Authorities suggested a US$5bn tranche was received at end-February, and another US$5bn in early March.

In regards to the immediate disbursement, authorities have clarified that US$10bn will be in direct cash, and the remaining will come from the conversion of US$5bn in existing UAE deposits at the CBE (likely the short-term deposits transferred in February 2022). Conversion will reduce net Fx liabilities of the CBE, even if this does not generate new non-resident Fx inflows.

This suggests to us that the second tranche could consist of US$14bn in fresh Fx resources and US$6bn in the existing (likely long-term) deposits at CBE to be used. (More precisely, CBE data suggests US$5.7bn in long-term UAE deposits at the CBE).

If all of the UAE CBE deposits are used to fund the Ras El-Hekma deal, this should extinguish all CBE Fx liabilities to the UAE. However, as suggested by press headlines, there could be residual deposits that are retained at the CBE and ring-fenced to fund other future UAE FDI deals.

The IMF previously required under the existing program that no CBE Fx deposits would be converted to fund FDI and privatization deals. However, IMF statements suggest a change in view given the changing circumstances now.

Authorities are negotiating further FDI mega-deals

Press reports suggest that authorities are drawing plans to develop the Ras Gamila area near the resort of Sharm el-Sheikh and across the Red Sea from the Saudi NEOM mega-project for a price tag of US$15bn. We suspect talks are at a very early stage. Press reports also suggest negotiations with China on the construction of the largest industrial zone in Egypt, and to be dedicated to export-oriented industries.

Fx backlog could be fully cleared through use of UAE proceeds

We suspect a large portion of the initial US$10bn tranche of the UAE FDI deal could be sufficient to clear the Fx backlog. This would support the gradual unification of the Fx markets to allow an unhindered and fully-functioning official Fx market. Public sector banks have introduced high-interest rate Certificate of Deposits (CDs) to mop up liquidity and encourage de-dollarization.

We estimate the Fx backlog could consist of a) cUS$10bn in imports, as proxied by the reduction in 12-month trailing imports (with an illustrative reduction to cUS$6-7bn post-devaluation due to the higher cost of imports or redundant orders); b) cUS$5bn in delayed outflows from Treasury-bills (T-bills) and Treasury-bonds (T-bonds), as proxied by the difference between their current and lowest foreign holding levels as well as our estimates for likely indexed outflows; and, c) cUS$5bn in arrears to International Oil Companies (IOCs).

A return of foreign interest in Local Debt Markets (LDM) or a re-investment of existing positions at higher domestic rates and more competitive EGP levels could help offset the cUS$2bn in outflows linked to the exclusion of Egyptian bonds from the Government Bond Index - Emerging Markets (GBI EM) index.

We suspect that the IOCs arrears will likely be repaid in installments over the duration of the IMF program, as per the precedent of the 2016 IMF program, and in line with the requirements of no accumulation of external arrears.

IMF program upsizing in line with expectations

IMF statements indicate that access under the original Extended Fund Facility (EFF) has been augmented from SDR2.35bn (cUS$3bn) to SDR6.11bn (cUS$8bn), broadly in line with market expectations. A Staff Level Agreement has been reached on the completion of the EFF first and second reviews. The IMF Executive Board is due to meet to review the program and augmentation access by end-March. No clarifications have been provided as to the rephasing of the program duration.

General government fiscal stance to be reviewed

IMF statements suggest a novel framework to slow down off-budget infrastructure spending is a pillar of the revamped IMF program. This would ensure that the impact of central government fiscal consolidation is not diluted by unabated public spending elsewhere, in our view.

Authorities indicated that they would limit the total public investment (from the budget, State Owned Enterprises, economic authorities, and other entities) at EGP1trn. The data does not clearly indicate how restrictive such a target could be. CBE data suggests total public investment stood at EGP0.56trn in FY21 (Fiscal Year ending in June).

Key is remaining international support

Mobilizing further international financing assurances will likely be key to support the external outlook. Authorities indicate they are likely to reach an agreement on a cUS$1.2bn Resilience and Sustainability Facility (RSF) to supplement the EFF program and to be disbursed in multiple tranches over the EFF arrangement duration.

Authorities indicate the IMF EFF disbursements will be supplemented by US$12bn in funding from the World Bank and the European Union (EU). The EU indicated in mid-November 2023 it proposed an EUR9bn (US$9.8bn) investment plan in Egypt to be punctuated by an investment forum in the spring. This suggests that the World Bank residual funding (US$2bn) could have greater visibility and timeliness than EU support.

Eurobond yields sustainably below 10% handle could mean external issuance

Should the global backdrop turn more forgiving with global rate cuts in 2H24 alongside Egypt delivering on key IMF program conditionality, authorities may well attempt to tap the market later this year to cement the improved economic performance and the lower medium-term credit risk perceptions, in our view.

Modest inflation impact could bring real rates to positive in the summer

We estimate the c60% EGP devaluation to 50 could push headline inflation up by c6ppt. We assume a 12-month 25% Fx passthrough to consumer prices and arbitrarily assume that 60% of the economy has been already operating at the parallel Fx market. Thanks to favourable base effects despite the upcoming Ramadan effect, we see headline inflation peaking at 32%yoy over the coming months before gradually coming down as the CBE maintains a tight monetary policy stance. With the CBE's overnight deposit rate hike to 27.25%, real interest rates could be in positive territory in the summer. A gradual decline in inflation over FY25 could allow some easing by the CBE while retaining a positive real interest buffer (typically, 2ppt or more).

Preserving fiscal space is key

Government debt dynamics remain sustainable, to the extent that fiscal discipline can be restored and maintained after the initial shock, in our view. Devaluation mechanically pushes central government debt up by 2ppt to 92.5% of GDP over the 6-month period to end-FY24. Note that central government debt included US$26.3bn in Fx-denominated domestic debt in FY23 (11.4% of total domestic debt). This brought the share of total Fx-denominated debt in central government debt to 35.0% in FY23.

Large external debt amortizations to keep external picture tight

External funding requirements are likely to be at their peak over FY24 and FY25. On top of a current account deficit of cUS$8bn, short-term external debt stands at US$30.3bn (including US$15.4bn in Arab deposits), while medium- and long-term external debt amortizations stand at US$21.6bn in FY24 (including US$3.9bn in bilateral non-rescheduled debt, US$9.3bn in multilateral debt, US$5.7bn in Gulf Cooperation Council (GCC) deposits) and US$27.4bn in FY25 (including US$8.5bn in bilateral non-rescheduled debt, US$10.1bn in multilateral debt, US$5.0bn in GCC deposits).

Note that we do not take into account the conversion of the UAE deposits in the gross financing needs estimates above. The conversion would impact the financing needs and sources simultaneously by the same amount.

We estimate the proceeds of the second tranche of the UAE FDI deal could meet our projected US$5-10bn external funding gap over 1-2 years. In turn, this provides room to implement reform, boost rollover rates of bilateral debt, allow marginal net positive multilateral inflows (excluding the IMF), entice portfolio flows and support the build-up of CBE Fx reserves over the same period.

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