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Egypt’s Currency Devaluation Repercussions and Opportunities

Special Policy Brief
March 22, 2022

Overview

- On March 21, 2022, the Central Bank (CBE) and Government (GoE) of Egypt adopted several measures to respond to the inflationary pressures that are building up rapidly in the economy especially following the latest announcement of the Fed Reserve to increase interest rate, and the continuous fallout from the war in Ukraine which caused a hike in prices of energy and many commodities. These measures included increasing the interest rates and lifting-up controls on the exchange rate which allowed the Egyptian Pound (EGP) to depreciate by nearly 16% against the US Dollar (USD).
- The GoE also rolled out a package of incentives consisting of EGP 130 billion in tax relief, while moving up the timeline of already-planned social safety measures. While causing short term economic hardship, these decisions pose opportunities for future investors in Egypt.

Background

- The package of monetary and economic policies announced on March 21st is rooted back to September 2020, following the breakout of COVID-19, when the CBE intervened to stabilize the Egyptian currency exchange rate, financing this control through USD 8 billion of its reserve to establish a de-facto dollar peg system.

- In February 2022, significant foreign investments withdrew from the Egyptian market following the Russian war on Ukraine and the global investment uncertainty, leaving a major gap in the Egyptian investment landscape and leading major investment houses to predict further monetary actions from the GoE to cover for the flaring in the trade deficit and depleting reserve.

Finance

The war on Ukraine has aggravated Egypt's external vulnerabilities and weighed on its currency due to higher commodity prices, and reduction in portfolio investments (which the GoE relied on to finance this deficit and defend the currency.) A Reuters article in early March 2022 estimated portfolio outflows from Egypt at USD 3.0 billion in the aftermath of Russia's invasion of Ukraine.

Tourism

Ukrainian and Russian tourists comprise a large share of the rebounding tourism industry in Egypt, with Ukrainians representing 30% of total tourists in the Red Sea area. Egypt witnessed a 25-30% decrease in the number of Russian and Ukrainian visitors to the Red Sea in February 2022 alone.

Implications of Ukraine Crisis

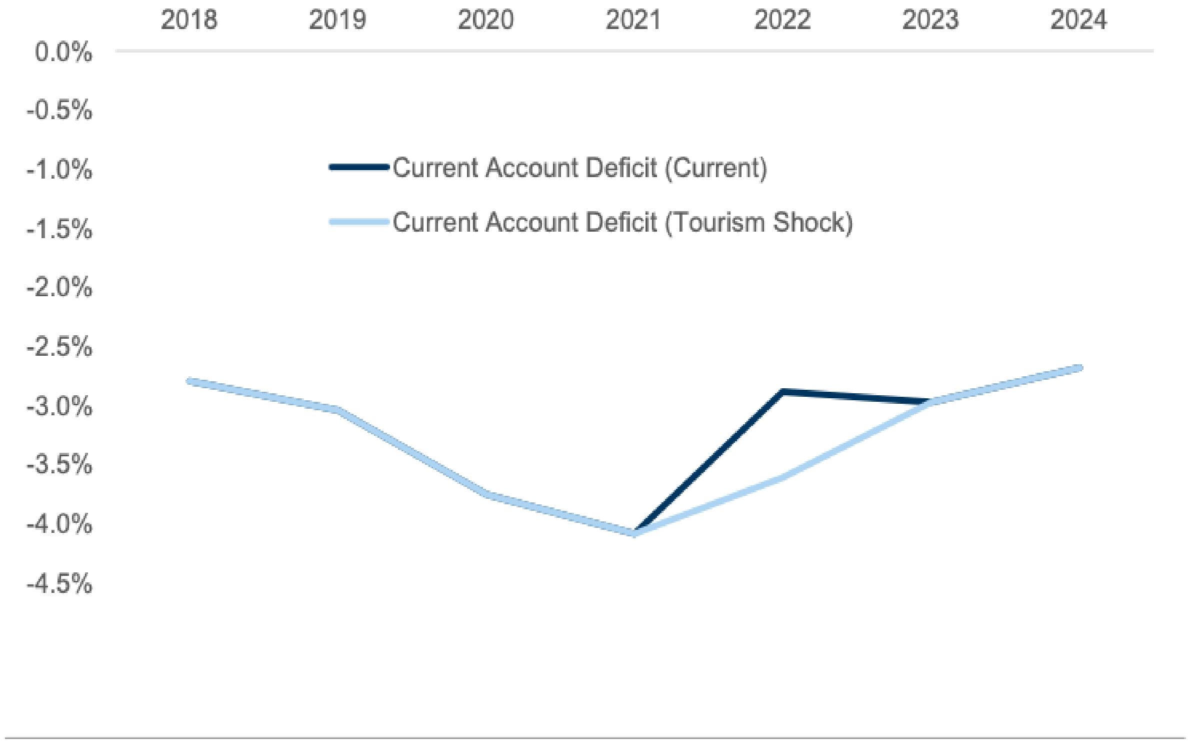
Current Account

Projections indicate that the loss of Russian and Ukrainian tourism in 2022 is likely to increase the current account deficit by 0.7pp of GDP, requiring additional external funding of USD 3,500,000,000 in 2022.

Commodities

Russia and Ukraine are the largest suppliers of wheat, corn, and sunflower oil, for Egypt. In 2020-21, 85% of wheat imports in Egypt in came from Russia and Ukraine alone.

Halt of Russian/Ukrainian tourism would widen current account deficit by approx. 0.7% of GDP

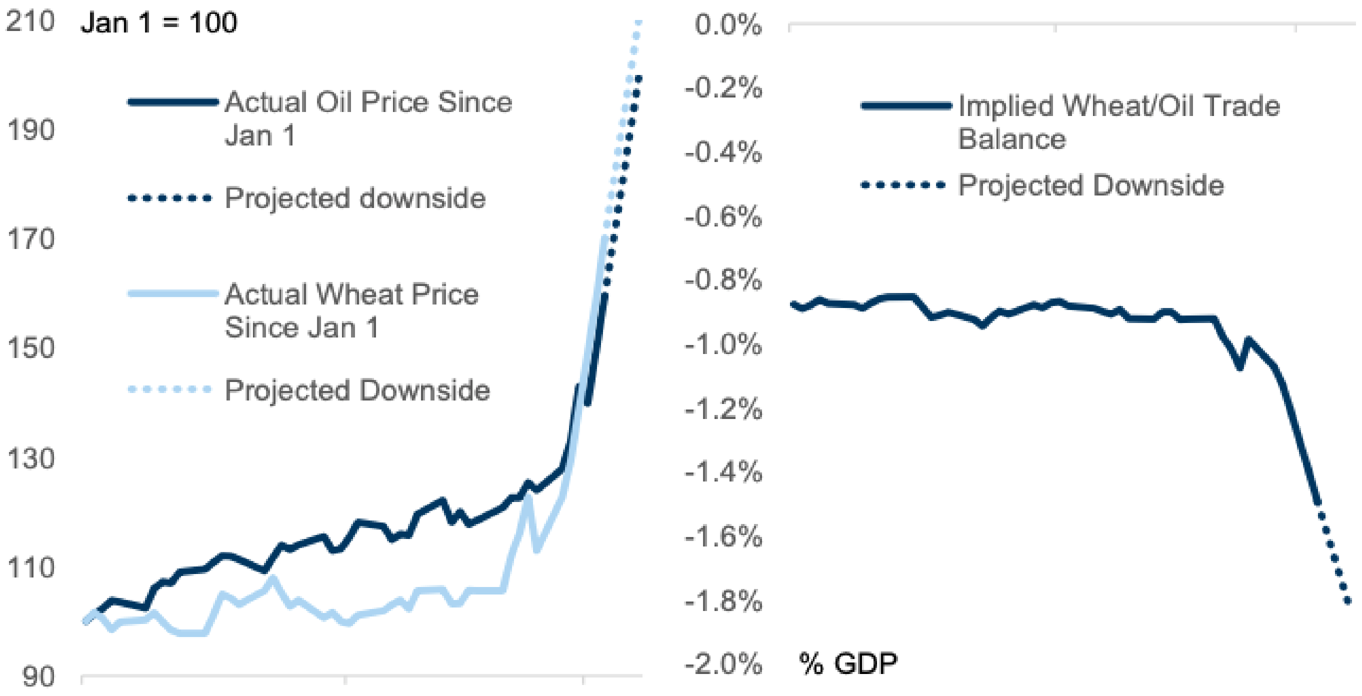


Source: Haver Analytics, Goldman Sachs Global Investment Research

Implications of Ukraine Crisis

Projections indicate that, if sustained, the rise in international wheat and oil prices would lead to a deterioration in the trade balance by 0.5pp of GDP in 2022.
Should the wheat and oil prices further increase, the deterioration in the trade balance could reach 0.8pp of GDP.
This is an extreme scenario as it assumes that Egypt's procurement at these prices will continue. However, Egypt currently has four months of wheat reserves. The local harvest season, which starts in April, is likely to provide another four months of wheat supply. Nonetheless, the scenario implies that the GoE will require additional external funding of USD 4,500,000,000 in 2022.
The GoE has now taken measures to place a price cap on unsubsidized bread, while it continues to consider rolling out a mechanism that may lead to a gradual increase in the price of subsidized ones.

Wheat and oil balance could deteriorate by 0.8 pp of GDP if prices double.
(where current price= average annual price)



Source: Bloomberg, Haver Analytics, Goldman Sachs Global Investment Research

Implications of Ukraine Crisis

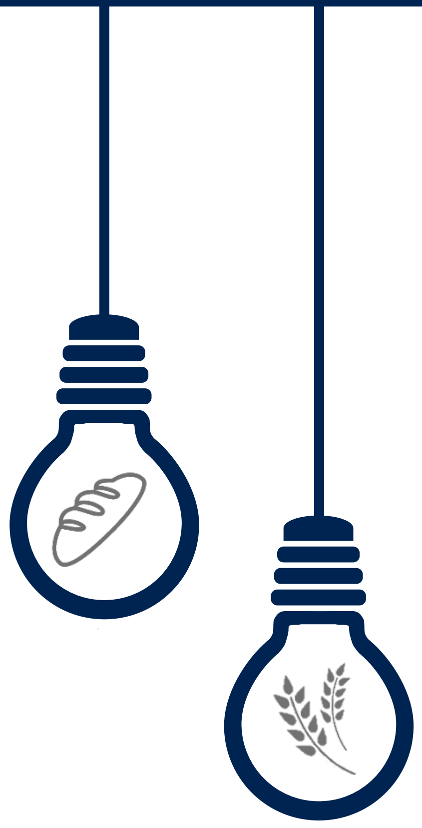
- In the extreme scenario outlined in the projections, the impact of wheat and oil prices, and the loss of Russian and Ukrainian tourists, could increase the GoE's external funding requirement by USD 8,000,000,000 for 2022.

- Currently, the CBE's gross FX reserves stand at USD 49,000,000,000, and a funding gap of USD 8,000,000,000 would be manageable, according to experts.

- Nonetheless, the impact of the Russia-Ukraine conflict on market sentiment and the possibility of further market instability, may threaten Egypt's external balances in the short term.

- Recently, there has been a significant outflow from the local debt market, which puts pressure on the Egyptian Pound, as seen from a rise in Non-Deliverable Forwards (NDFs).

- Prior to the conflict in the Black Sea region, foreign holdings of Egyptian debt stood at USD 29,000,000,000. If that amount decreased by 50% in 2022, it would raise the external funding requirement to USD 22,000,000,000, which would threaten half of the CBE's FX reserves, highlighting the need for the GoE to take urgent action.



Package of Economic and Monetary Policies (21/3/2022)

The CBE and Ministry of Finance announced a package of economic and monetary policies in response to escalating inflation and the need to keep Egypt attractive to the global carry trade, increasing investor confidence. This package includes:

01 Interest rates

Raising the overnight deposit rate, the overnight lending rate and the rate of the main operation by 100 basis points to 9.25 percent, 10.25 percent, and 9.75 percent, respectively. The discount rate was also raised by 100 basis points to 9.75 percent.

02 Capital Markets

Reducing the capital gains tax on gains made from IPOs on the EGX by 50% for the next two years and putting in place new tax exemption for share-swaps between listed and unlisted companies

03 Social Safety Nets

Including 450,000 new families eligible for transfers under the Takaful and Karama social security programs. Also raising annual pension payments and salaries for civil servants, effective April (instead of July) 2022.

04 Trade

Reintroducing the monthly customs exchange rate, setting it at EGP 16 for imports of basic commodities and materials used for manufacturing and vehicles. The rate will be fixed until the end of April 2022.

(Egypt had scrapped the monthly system in 2019, after initially introducing it in 2017 following the November 2016 EGP floatation as an “exceptional measure” to stabilize the customs rate.)

05 Taxation

Raising the ceiling for income tax exemptions and providing manufacturers with a three-year real estate tax holiday, which is expected to cost the GoE approximately EGP 3.75 billion.

Repercussions and Opportunities

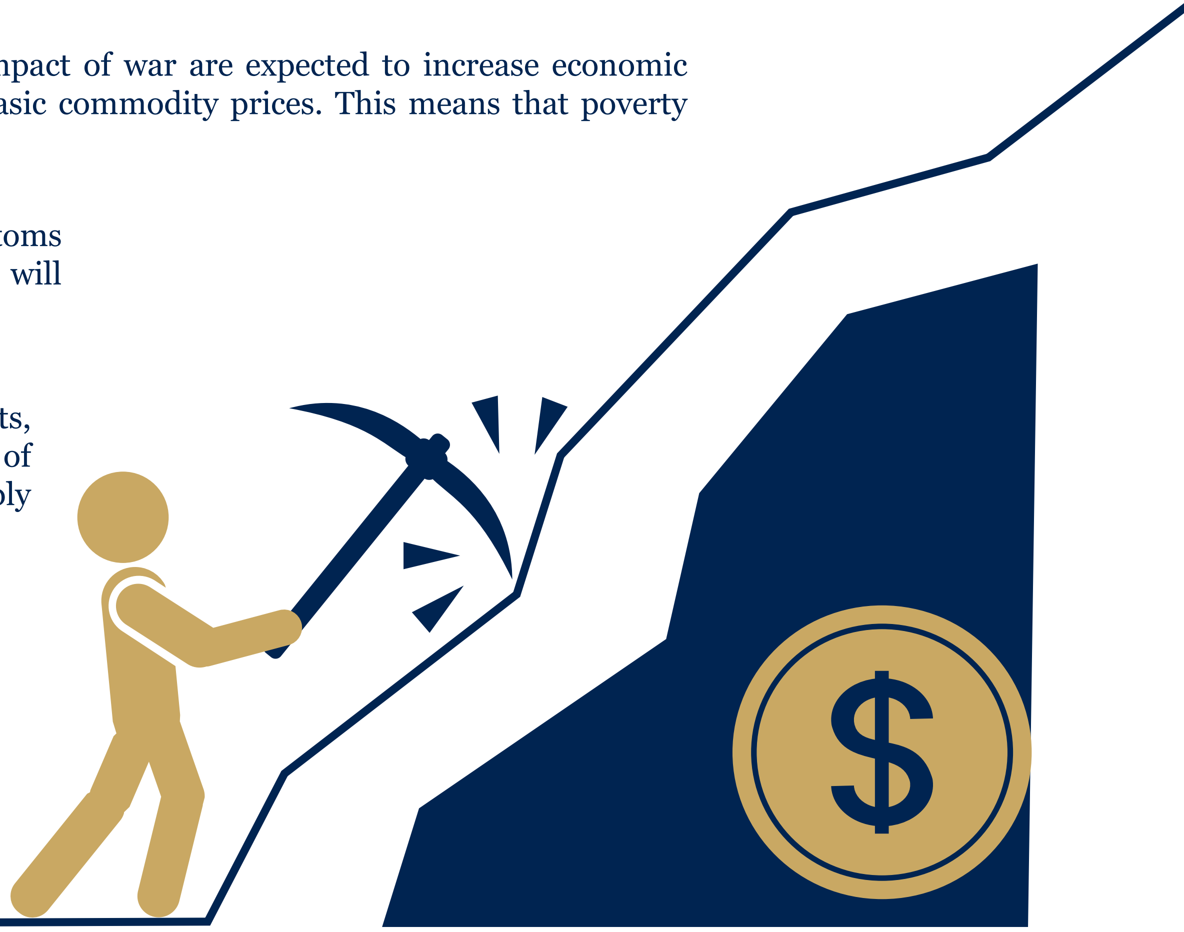
Social and Economic Effects

01 The decline of almost 16% in EGP exchange rate combined with the impact of war are expected to increase economic burdens on Egyptian citizens following the rise in prices for fuel and basic commodity prices. This means that poverty rates are likely to increase in the short and medium terms.

02 Price increases, currency depreciation as well as the application of a customs exchange rate will add extra burden on the balance of payments which will worsen Egypt’s external sector performance.

03 Shortages of foreign currencies have led to blockages at Egyptian ports, after importers could not obtain necessary foreign currency for letters of credit to get their goods cleared. This will create bottlenecks in the supply chains and is expected to distort the market.

04 The rise in USD price in exchange for the EGP will inflict further budget deficit resulting from the government foreign debt payments abruptly increasing. This will be mitigated by the financial assistance of the IMF which is currently being negotiated.



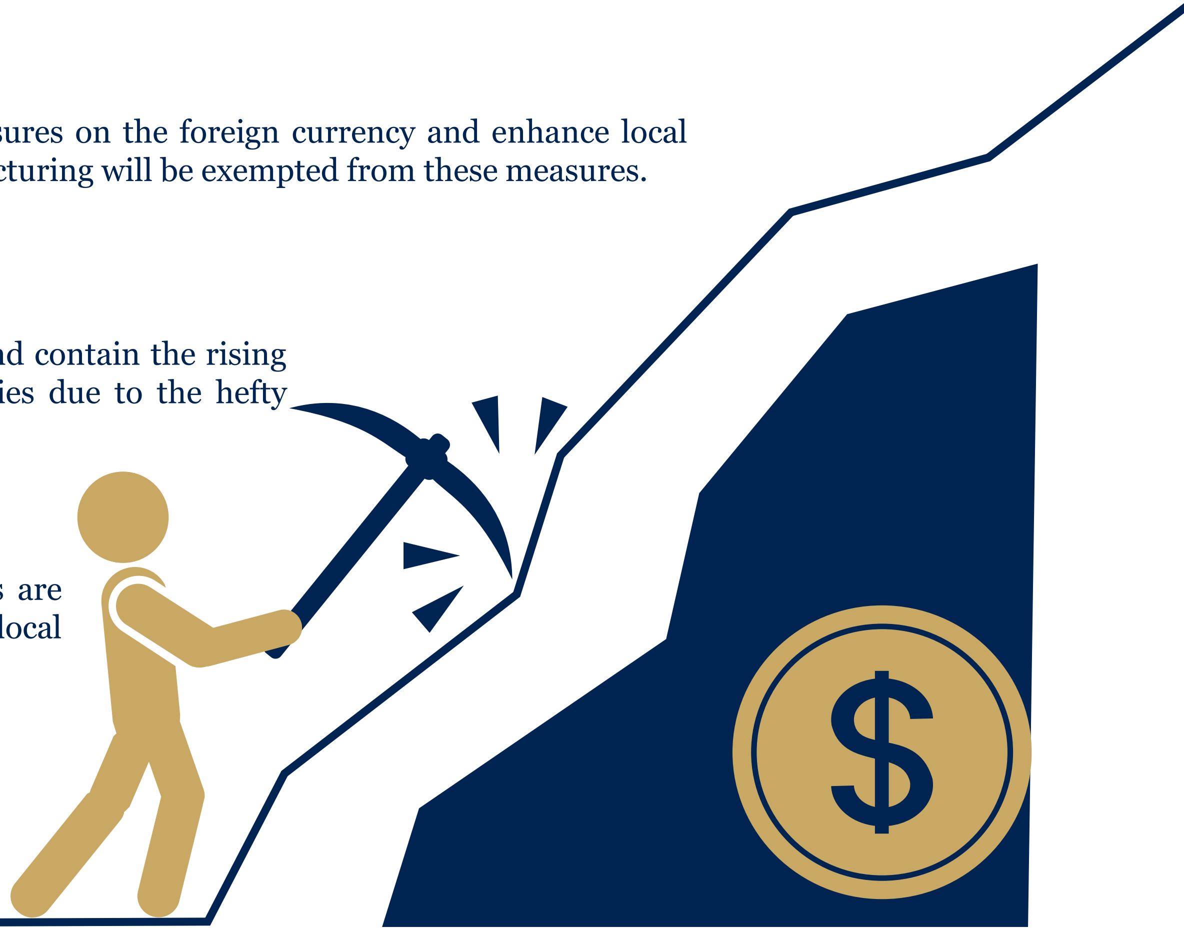
Repercussions and Opportunities

Social and Economic Effects

05 Further measures to limit imported products are expected to ease pressures on the foreign currency and enhance local production. Imports of basic commodities and materials used for manufacturing will be exempted from these measures.

06 Banks increasing interest rates from 11% to 18% to withdraw liquidity and contain the rising inflation rates might lead to negative effects on the investment activities due to the hefty financing costs.

07 Additional announcements to stimulate local manufacturing operations are expected, including the roll out of an automotive strategy to support local automotive manufacturers and attract new investments in the sector.



Repercussions and Opportunities

Investment Outlook

The GoE is clearly moving early and swiftly to address the repercussions of the war on Ukraine by seeking to re-attract foreign investments following the devaluation and lowered control over the currency price.

A new package of investment reforms and additional GoE support to foreign investors to alleviate the inflation rise impact is projected. It's worth noting that the the GoE recently rolled out additional incentives for green and AI projects.

Economists at Goldman Sachs indicated that the EGP devaluation is likely to generate inflows of foreign currency and might hold the outflow impact. It is unlikely for the foreign holder of Egyptian T-bills to sell now to avoid short term losses.

Revival of stock exchange is also possible if the GoE decides to move forward with its long-awaited IPO program.

The Sovereign Fund of Egypt (SFE) is also lining up investments for Egypt worth more than USD 2 billion, led by "foreign and strategic private-sector investors." According to a GoE statement, some of the USD 2 billion would be deployed through the EGX, while a portion would be invested directly by SFE.

Repercussions and Opportunities

Investment Outlook

- Additional collaboration with Gulf Cooperation Council countries to introduce more investment inflows may occur.

- Compared to previous attempts at handouts from the GCC countries, the GoE is signaling interest in accelerating the process of offering attractive assets to GCC buyers, including sovereign wealth funds.

- According to a Bloomberg report (21/3/2022), the Egyptian state has agreed to sell some of its holdings in five EGX-listed companies. The report added that Abu Dhabi wealth fund ADQ will purchase stakes worth USD 2 billion.

- Bloomberg added that this includes up to 18% of shares in the *Commercial International Bank (CIB)*, the country's largest private-sector bank, as well as an unspecified stake in the fintech company *Fawry*, alongside three other companies.

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