Market Insights & Strategy
Global Markets

Egypt's Currency Dilemma

The news this past Sunday that Egypt had finalized a US$2.7 bio currency swap agreement with China was a welcome development; it means that the country has probably reached its US$6 bio target in additional external financing, which was a key condition around the IMF's US$12 bio loan program. Other key reforms such as the introduction of a value-added-tax have also been implemented, but the most sensitive issue namely a more flexible FX regime still awaits action.

The debate over which direction the authorities will take with regards to the local currency has been ongoing for months, and until very recently we ourselves felt that as soon as the IMF funds have been secured the Central Bank would devalue the Egyptian Pound sharply and then introduce a "managed float." However while the IMF's board approval is still very likely to take place within the next few weeks, we have now altered our potential outlook for the FX regime and think that the Egyptians may decide to go for a "big bang" approach and thus allow for a free-float instead.

The reasons for this change in our expectations has been driven in part by recent public comments over the planned economic reform program made by both government and IMF officials. For example President Sisi and Prime Minister Sherif Ismail have issued a number of statements these past few weeks underlining the fact that these reforms are "necessary" and will, initially at least, mean harder times for the average Egyptian. These are obvious attempts to prepare the population for substantial fiscal tightening such as the removal of some subsidies and a weaker currency etc. At the same time the supply minister, has announced that the government is working on building up sizeable reserves of essential foodstuffs, such as wheat, sugar and rice, enough in fact to cover six-months demand, this could be a pre-emptive move to ensure that the most vulnerable sections of society are protected from any jump in prices following a major drop in the value of the currency.

On the question of the potential inflationary effect of a weaker pound, an IMF spokesperson said that in general prices in Egypt already reflected the unofficial parallel exchange rate, because many businesses have been forced to access their US dollar requirements via that route due to capital controls and an ongoing hard currency shortage. Unfortunately rising expectations of another major devaluation of the official rate has also sparked some hoarding of dollars which in turn continues to drive the USD/EGP "kerb" rate to new highs. (Yesterday the pound was reportedly changing hands at 18.00 on the street against an official rate of 8.78/8.88).

Fundamentally we are now at a stage where just another devaluation may not reverse the tide, both businesses and investors need to have a proper functioning currency market in order for liquidity and confidence to return. Other countries have experienced similar pressure on their currencies in the past, most recently Kazakhstan and Belarus discovered that attempting to fight against the flow was a losing battle, and in the end very costly to their limited reserves of foreign exchange. Egypt's Finance Minister, Amr El Garhy, said earlier this month that his government will not use the funds Egypt receives from the IMF and the other bilateral lenders to defend the pound, these comments echo those made by the country's Central Bank Governor, Tarek Amer, back in July when he stated that the decision to try and protect the USD/EGP exchange rate over the past few years was "a grave mistake." Meanwhile the head of the IMF, Christine Lagarde, said just last

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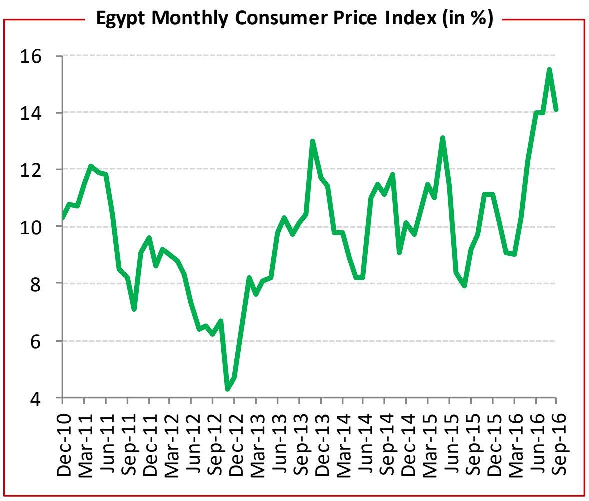
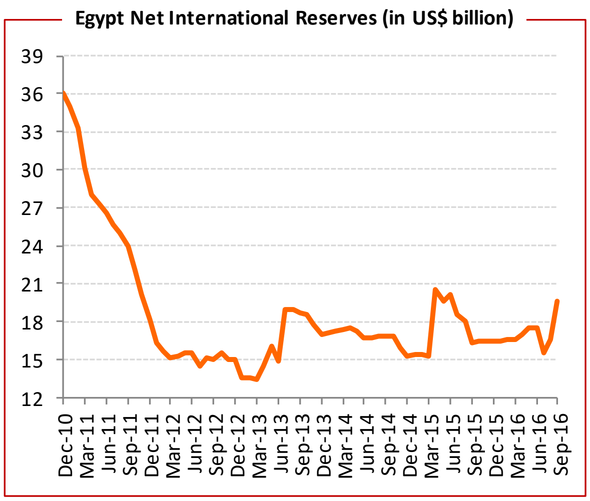
Glenn Wepener
Executive Director & Geo-Political Analyst, Middle East & Africa

week that Egypt was experiencing a "currency crisis," and made some clear comments with regards to whether a complete float or gradual devaluation was the right course of action for the country; "When you have very low reserves, when the difference between official and unofficial rate is very wide, historically we have seen rapid transitions being most efficient," Lagarde stated.

Of course the government's lengthy deliberations on this subject are also probably driven by concerns over the potential for civil unrest, following a sizeable devaluation of the official rate. But as discussed above the inflationary impact of a weaker exchange rate has now been overtaken somewhat by the growing scarcity of goods (which is itself inflationary), due to the acute hard currency shortage and hoarding, therefore any further delays in acting on the FX regime will just make the current situation worse.

In conclusion while a float would initially be painful it, combined with further reforms such as reducing red-tape and promoting transparency in order to create a better domestic business environment, may just be the best course of action to put this strategically important country back onto the slow road towards recovery.





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Glenn Wepener
Executive Director & Geopolitical Analyst
Middle East & Africa
Market Insight & Strategy Group
NBAD Global Markets
Tel: +971-2-6110141
Mobile: +971-50-6415937
Email: GlennMaurice.Wepener@nbad.com
Website: www.nbad.com