Prospects

No. 22/100 – 22 March 2022

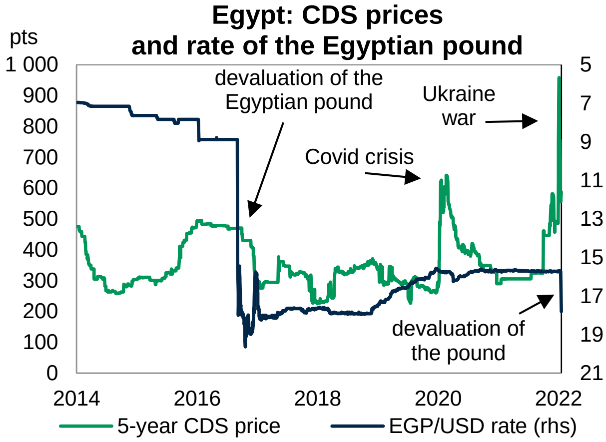
EGYPT – The country's intrinsic fragility has emerged again in the financial markets

Every external crisis that affects Egypt more or less directly leads to substantial capital outflows and financial market tensions. This was the case during the coronavirus health crisis and even more so this year at the start of the war in Ukraine. How can we understand the recurrence of these tensions during each crisis? In fact, Egypt, already weakened by double external and public over-indebtedness, is also caught in the contradictions of the significant opening of its capital account, an exchange rate regime fixed to the dollar that is too rigid and a monetary policy that is probably insufficiently reactive. This intrinsic fragility was reflected at the end of March 2022 in the 15% decline of the Egyptian pound against the US dollar and the increase in the key rate by 1% -100 basis points (bp) - to 9.25%. As during the 2016-2017 crisis, Egypt asked for a financial support from the IMF and Gulf countries; for an amount that could range between 10 to 20 bn USD.

The specific characteristics of the war in Ukraine, with rising inflation risks on food products and the risk of grain shortages, led to a high level of investor concern at the beginning of March 2022.

The most immediate consequence is that the Egyptian pound fell 14% against the US dollar on 21 March. This adjustment was preceded by a sharp increase in the sovereign risk premium in early March (CDS prices, five-year sovereign default risk insurance policy), which rose to more than 1,000bp (more than 10%) at the beginning of March. It fell back to 588bp at the end of March after the exchange rate adjustment and thus returned to the level reached at the start of the coronavirus health crisis. This illustrates the concern of portfolio investors about Egypt's level of public debt. The lower return on government securities (11.3%) due to the rise in inflation (8.8% in February) may also have negatively impacted the attractiveness of T-bills.

Egypt: CDS prices and rate of the Egyptian pound



Sources : Morgan Stanley, Reuters, CA S.A.

There are several reasons for the current market adjustments:

An exchange rate regime that is too rigid. The exchange rate regime, initially planned to be flexible during the 2017 devaluation, is, in fact, an exchange rate regime fixed to the dollar. The rate of the Egyptian pound has remained almost unchanged at 15.7 against the dollar for the past two and a half years, before 21 March. This too rigid policy, partly due to the desire not to cause imported inflation, is also due to the recent increase in public debt in hard currency. Currency depreciation would automatically increase the public debt ratio, whereas it was already at 90% of GDP at the end of 2021. As long as GDP growth exceeds the current account deficit, tensions remain contained. However, this was not the case in 2020 and 2021, due to the collapse in tourism revenues as a result of the health crisis. This partly explains the current devaluation of the Egyptian pound to 18.2 per USD, a level close to the average rate of 2018, after the

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devaluation in 2017. The current account deficit, which is likely to remain at the 2021 level (-4.5%) due to the increase in the prices of many import products (grains but also metals and oil) before this devaluation, could contract to only 4% of GDP in 2022 given this exchange rate adjustment and according to our estimates. Another automatic consequence is that the devaluation of the exchange rate adds USD 12 billion to the public debt (share of 20% of public debt denominated in foreign currency), which is likely to increase the public debt-to-GDP ratio from 90% to 93% by mid-2022.

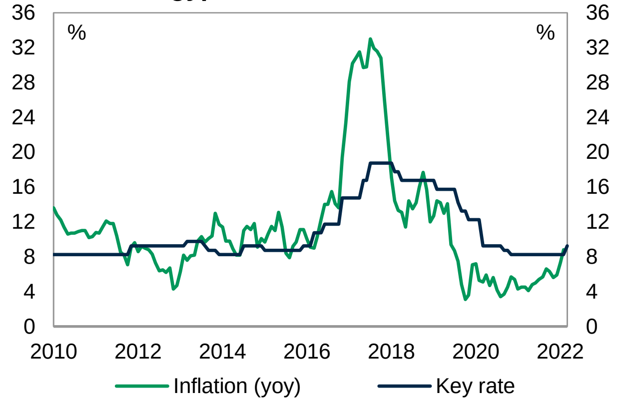
Too much speculative capital. The Covid health crisis caused the flight of USD 11 billion in portfolio investments between March and May 2020, resulting in foreign currency reserves falling to USD 36 billion, a very significant drop of 30%. The latter required the IMF's intervention to stabilise these reserves. This capital, by nature volatile, only returned in 2021 on the back of respectable macroeconomic figures during a crisis and favourable market opinions, thus stabilising the sovereign risk premium at 300bp. The predominance of volatile capital to the detriment of more sustainable foreign direct investment (FDI) saw a further sharp increase in 2021. In September 2021, FDI accounted for only 1.2% of GDP (less than USD 5 billion), compared with 1.5% in 2020. It's really too little for an emerging country that, for a long time, has wanted to attract productive foreign capital. This illustrates the wait-and-see attitude of long-term investors and it is, of course, an additional fragility for a country with an open capital account and that increased its current account deficit to around 5% of GDP in 2021. In 2021, portfolio investments were estimated at USD 15 billion, an amount three times higher than FDIs.

Rising inflation. The upsurge in inflation seen in early 2022 (7.3% in January and 8.8% in February) will continue during the year, partly due to the rise in food prices (they were up 17.5% yoy in February), and particularly wheat on the international markets (Egypt is one of the world's largest importers), but also the high weighting (44%) of food products in the final index. Monetary policy, as it generally does, took into account the deterioration in inflation on 20 March and the Central Bank raised its key rate by 1% (100bp), to 9.25% (deposit rate). An average inflation reaching 10% in 2022 (calendar year) is possible as imported inflation will add more pressure on prices of imported goods after the currency depreciation.

Too many debts and tight liquidity. Moreover, the country's main vulnerability remains its level of external and public over-indebtedness, which saw a further slight deterioration during the Covid crisis. While external debt is modest as a percentage of GDP (34%), the country's low level of openness (exports amount to 40% of GDP) has pushed the debt ratio to more than twice export earnings from goods and services. It was a level of over-indebtedness that required assistance from the IMF in 2016 and 2020, which also increased external debt.

As consequence of the fragilities, the authorities asked for external financial help to the IMF and three Gulf countries. External financing requirements are estimated at USD 49 billion per year for the two fiscal years 2021-2022 and 2022-2023. Considerable amounts representing between 10% and 11% of GDP. Tight liquidity has required the renewal, and the increase, of ad-hoc assistance from Gulf countries and multilaterals, also because tourism revenues are slow to return to their pre-crisis level and will remain low due to the impact of the war in Ukraine. Four Gulf countries have already given 12 bn USD financial assistance in the past and three of them committed to renew and/or extend this help by 12 bn USD new investments, whether by direct liquidity support to the Central bank (Saudi Arabia) or by capital investments in the Cairo Stock Exchange (Emirates and Qatar). AThe government also asked IMF financial assistance, a third plan after the 2016 and 2020 plans (20 bn USD). The amount of this help is undisclosed at this stage. . The State is also using all the tools available to borrow on the financial markets: it has recently confirm its first international sukuk issue in USD and new sovereign domestic issues that should be bought by domestic banks, the main creditors of sovereign debt.

Egypt: inflation and rates



Sources : Central Agency for Statistics, CA S.A.

☑ **Our opinion –** *The risk of social tensions in the event of food shortages is also not to be minimised. The government could therefore resort to the weapon of subsidies to mitigate the financial impact of rising food prices on the poorest households. This social policy, although justified, could make it more difficult to meet the budget deficit reduction targets, while debt repayment already absorbs 30% of government revenues. One of the highest ratios in the world.*

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