Prospects

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EGYPT – Retrospective of a currency crisis: how to build confidence?

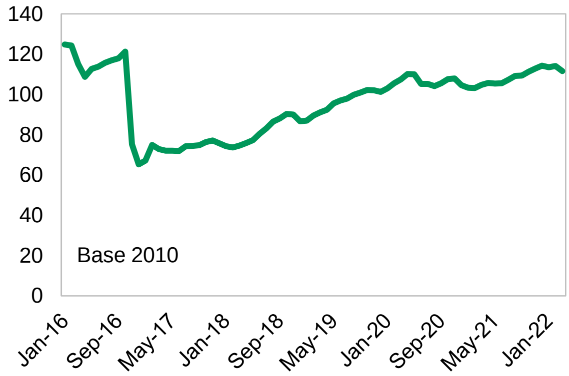
- **The Egyptian economy, though weakened, is recovering from a two-year external liquidity crisis. The crisis reminds that indebted countries dependent on external financing are vulnerable to investor confidence.**
- **The market's loss of confidence in the Egyptian currency led to a wave of pessimistic and self-fulfilling currency expectations. As a result, the value of the Egyptian pound became utterly dependent on market speculation.**
- **Thanks to substantial funding from the United Arab Emirates and the IMF, the country's external liquidity risk has materially eased. But this is not a long-term blank check of confidence. In the event of a crisis, Egypt would remain vulnerable to a reversal of expectations.**
- **Exiting the crisis hinges on transitioning to a flexible exchange rate system. But this will not suffice if the country fails to build a more solid economic model able to anchor investor expectations over the long term.**
- **Furthermore, Egypt not only needs a flexible exchange rate but has also to limit the impacts of this flexibility on its impoverished population without depleting its remaining budgetary resources.**
- **Hence, a review of the recent and turbulent history of the Egyptian exchange rate helps outlining the economic challenges that lie ahead and understanding the official creditors bet on this country.**

Anchoring expectations on a credible exchange rate system is central to the Egyptian government's strategy to exit the crisis. But this is nothing new. Since 2016, the IMF support has been conditional on transitioning to a flexible exchange rate. The solution seems simple enough: it has already been implemented in other emerging countries. But in Egypt it has come up against a complex ecosystem of economic policies. Behind the scenes, the transition of the Egyptian exchange rate system has proved particularly turbulent.

Flexible exchange rate: from narrative to reality

In 2016, the promise of a flexible exchange rate supported by an IMF programme and a substantial adjustment of the Egyptian pound against the US dollar pulled Egypt out of a severe liquidity crisis. Between 2016 and 2022, the appreciation of the Egyptian currency in real terms - counter-intuitive given the country's persistent current account deficits - did not appear to undermine the credibility of the exchange rate transition.

Real effective exchange rate 2016-2022



Sources: Crédit Agricole S.A./ECO, JP Morgan

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But in 2022, the outbreak of war in Ukraine, which increased the price of imports[1], clearly revealed the symptoms of the Egyptian pound's misalignment both with economic fundamentals and the terms of trade. The shortage of dollars, swiftly exacerbated by capital flight, blocked imported goods at ports. The parallel foreign exchange market deepened and banks drew on their net foreign assets to settle their transactions in dollars. The rigidity of the official exchange rate when confronted with the external shock questioned the credibility of the exchange rate system. It also pointed to a more structural pattern: a degree of institutional incoherence, from an economic governance model unsuited to a floating exchange rate regime.

The Egyptian economy remains extremely centralised and in part administered. This long-standing approach to economic policy does not lend itself to market-driven exchange rates. Nevertheless, until 2022 the authorities endeavoured to establish a compromise: keeping up the tradition of a centralised economy internally and, externally, anchoring market expectations through a narrative of currency flexibility.

De-anchored expectations

With the outbreak of war in Ukraine, this compromise became a balancing act between (artificially) stabilising the exchange rate and attempting, in fits and starts, to catch up with collapsing expectations. This created confusion on the markets and eroded confidence in the Egyptian central bank's ability to find a solution to exit the crisis. This policy led to a series of devaluations (-15% in March 2022, -19% in October 2022 and -17% in January 2023) which failed to restore confidence.

In February 2023, the Egyptian pound had been devalued by more than 50% while failing to re-anchor expectations. At the time, speculation on the value of the Egyptian currency (parallel market premium, forward contracts, etc.), reported on a daily basis in the press, exacerbated the loss of market benchmarks, leaving an unresolved central question: what is the equilibrium value of the Egyptian pound? How much will it fall?

Where do the structural external imbalances come from?

The Egyptian currency's vulnerability to foreign investor sentiment ultimately results from substantial and structural deficits in the balance of goods, which have made the country dependent on large external financing. In 2023, despite constrained imports due to US dollar shortages[2], the balance of goods deficit reached $31bn, or 8.1% of GDP, compared with an average of 11% in 2018-2022. These deficits result from years of low productive investment, which constrained export growth. Meanwhile, imports increased more rapidly, driven upwards by a strong domestic demand.

Strong domestic demand underpins external imbalances

Egyptian GDP growth is mainly driven by private consumption. The latter contributed to 83% of GDP on average over 2018-2022, 10pp above the average for 2005-2009, preceding the Arab Spring. The steady private consumption is the key factor behind the resilience of Egyptian growth, which has not suffered a recession despite the major crises of the last 15 years (including the Arab Spring, a military coup, terrorist attacks, liquidity crises, and COVID).

Consumption is boosted by a a dynamic demographics (around 2% growth p.a.); high inflation, which discourages savings (extremely low, at 10% of GDP in 2023); and substantial financial support from the diaspora. Remittances amounted to 8.5% of GDP on average in 2017-2021. They have had a significant impact on the partial decorrelation of household consumption with the economic environment. They have proved broadly resilient to shocks, and in particular to the COVID pandemic, as they respond to a solidarity pattern. While the contribution of these revenues to the balance of payments' receipts decreased drastically during the 2022-2024 currency crisis ($10bn shortfall in 2023), informal networks took over, cushioning the impact of the Pound's devaluations on consumption.

In comparison with this trend, the contribution of investment to GDP has stagnated. Investment had barely recovered its pre-Arab Spring level in 2019 (20% of GDP), but, as of 2022, it had deteriorated to 17% of GDP. This reflects the depressed business environment, as captured in particular by the PMI, which has pointed toward a constant industrial contraction since 2022. The country's economic instability has prompted a wait-and-see attitude. However, the authorities have launched a large-scale plan to encourage investment. The plan aims to reduce administrative complexity, strengthen regulatory institutions' autonomy, and amend legal provisions offering preferential treatment to state-owned enterprises.

Lastly, major infrastructure projects (including the new capital) led by state-owned enterprises have contributed to the overheating of domestic demand. These projects require significant import flows and have been identified by the IMF as a factor of external imbalances. They are particularly reliant on capital goods, one of the country's largest import categories. Consequently, the revised IMF programme calls for a slowdown in these projects and insists on tighter oversight.

[1] Cereals – the price of which has been heavily impacted by the war in Ukraine – are Egypt's biggest import, totalling $6.5bn in 2023, 60% of which wheat.

[2] In 2023, non-oil imports fell by more than 20%, to $57bn, compared with $74bn in 2022.

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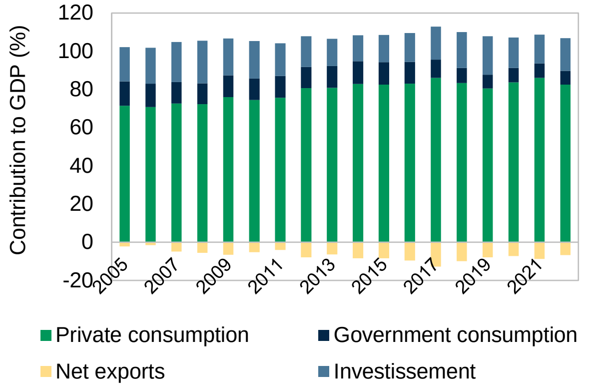
Egyptian GDP is driven by private consumption



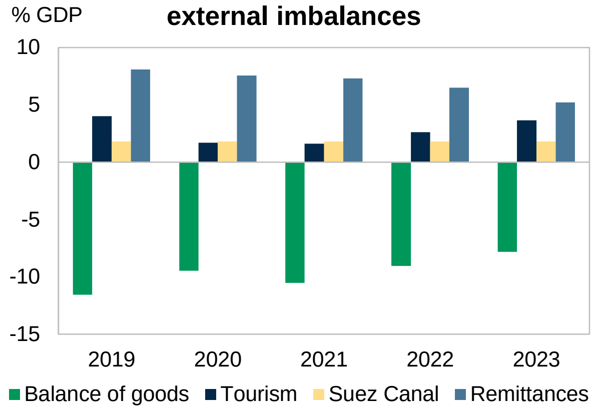
Sources: Crédit Agricole S.A./ECO, Ministry of Planning

[3]

The commissioning of the Zohr gas field in 2018 has, for a while, supported the reduction of the balance of good's deficit. The oil and gas balance even reached a surplus in 2022. But since 2023, the declining gas production has been absorbed by a fast growing domestic demand (especially in the summer season). In the first nine months of fiscal year 2024, the negative balance of hydrocarbons aggravated the current account deficit by -1.3% of GDP. This is a major new challenge for Egypt.

The deficit of the balance of goods is partly covered by Egypt's' main sources of hard currency: tourism, Suez Canal receipts, and remittances. But these revenue streams have proven volatile in times of crisis. They could also be impacted durably by ongoing regional geopolitical tensions. In particular, since end-2023, Suez Canal daily traffic has fallen by an average 50% under the threat of the Houthis in the Red Sea. Tourism is expected to be less impacted but will nevertheless suffer from tensions in the region.

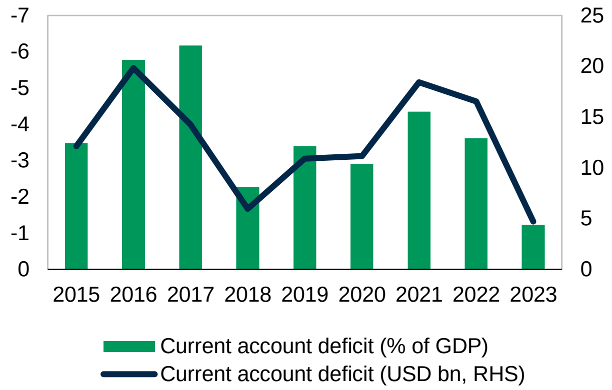
A large trade deficit underpins external imbalances



Sources: Crédit Agricole S.A./ECO, Central Bank of Egypt

The Egyptian economy is therefore constrained by high import needs, which heighten its dependence on a narrow base of hard currency income sources. This generates episodes of current account volatility, which tend to increase external financing needs when shocks occur. The challenge to mobilise sufficient external financing also derives from the large size of the economy, implying high nominal amount in dollars to raise from creditors. And in 2022, market access had become increasingly constrained.

Large nominal external Financing needs



Sources: Crédit Agricole S.A./ECO, Central Bank of Egypt

[4]

[3] The charts are presented by fiscal year (e.g.: 2023 corresponds to July 2022–June 2023).
[4] The sharp reduction in the current account deficit in 2023 was underpinned by a strong performance in tourism and revenues from the Suez Canal but above all by a contraction in imports resulting from the US dollar shortage.

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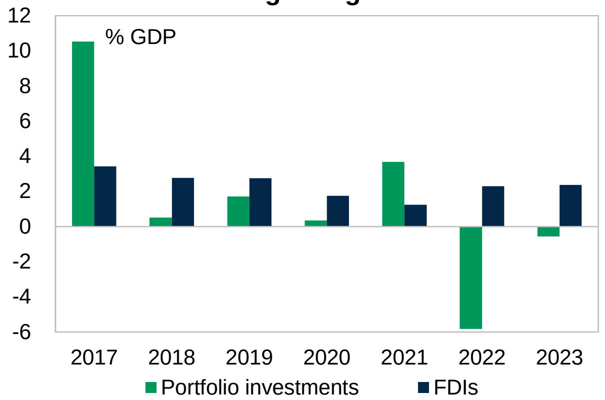
Capital flight reveals a hardly sustainable external financing model

Between 2016 and 2022, the influx of foreign investors into the high-yielding local-currency sovereign debt market boosted the country's liquidity, but masked the urgency of addressing external imbalances. The financial history of emerging countries shows that, when confidence disappears, this kind of short-term and opportunistic (by essence) financing quickly dries up (or is even widely withdrawn), serving to exacerbate the dollar shortage. This is what played out in 2022, creating strong downwards pressure on the Pound– and this pressure quickly became self-fulfilling.

Volatile portfolio investments and stagnating FDIs



Sources: Crédit Agricole S.A./ECO, Central Bank of Egypt

Once the economic agents witnessed that the dollar taps were closing, they hoarded dollars from export earnings, or remittances, and when needed, preferred to trade their dollars in the parallel market. This increased the dollar scarcity in the official market. In the final phase, all foreign investors, anticipating a further devaluation, started to postpone their investment decisions. **At this point, the loss of confidence started to play a central role in this three-stage liquidity crisis.**

2023: the long wait for the right momentum

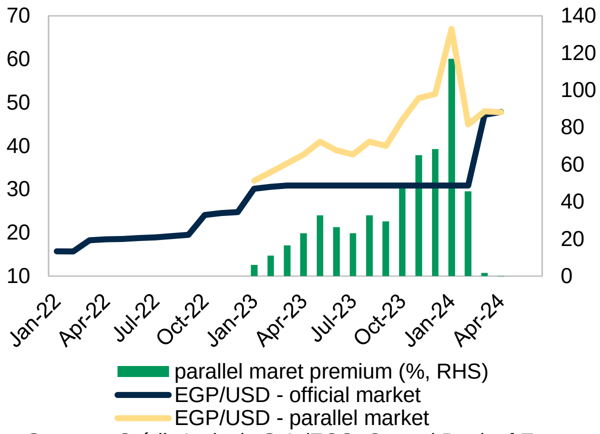
At the end of 2022, the IMF returned with the same medicine: a flexible exchange rate to restore investor confidence. Why change a winning formula? The approach is simple, magical almost: an exchange rate that constantly reflects supply and demand forces does not lie, it is reliable. But in practice, stabilising expectations is a more complex equation, especially after a cycle of devaluations.

Initially, if the pound is fully freed from all capital control constraints, it should naturally catch up with the parallel market. But if economic agents continue to hold on to the dollar, downwards pressure may increase. For the IMF program to succeed, foreign exchange liquidity had to be restored. Otherwise, there was a real risk of a currency collapse, with a substantial cost to inflation and macroeconomic and social stability. It also risked derailing the government's debt. In February 2023, the authorities reneged on their promise of a flexible exchange rate and began to prepare for the right moment to restore the credibility of the currency, i.e. the moment at which the cost of a new and inevitable monetary adjustment would be as low as possible.

In search of liquidity, Egypt turned to its natural strategic partners, namely the Gulf countries, to which the country proposed an asset privatisation programme. But transactions were slow to materialise, further eroding the confidence of investors, doubting the support of the Gulf Cooperation Council countries. The issue of asset valuations also became more complex, as Egypt refused to discount its performing assets based on a currency forecast that it believed reflected a time of crisis rather than its fundamentals.

As a result, the propitious moment for currency adjustment was slow in coming, and this delayed the IMF's programme, in turn serving to increase market uncertainty. When the war between Israel and Hamas broke out, simultaneously disrupting Egypt's two major dollar sources (tourism and Suez Canal revenues), the expectations of economic agents raced towards a breaking point (with the parallel market exchange rate reaching almost 70 EGP/USD against an official exchange rate of 31 EGP/USD).

Exhange rate expectations



Sources: Crédit Agricole S.A./ECO, Central Bank of Egypt

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The IMF's bet, backed by the Gulf

Against this backdrop, the intervention of Abu Dhabi, which signed the Ras Al-Hekma development agreement in February 2024, valued at $35bn, including $10bn up front[5], took on the appearance of a rescue plan. Reassured about Egypt's ability to face its external payment obligations and replenish foreign exchange reserves (which stood at $46bn in May, equal to nearly 5 months of current external payments, up from 3.8 in February[6]), the markets calmed at last, allowing the authorities to make the necessary monetary adjustment to restore stronger confidence in the pound.

The role of the Gulf partners

In its April 2024 investor newsletter, the Ministry of Finance reported on the progress of the privatisation programme, the main transactions of which are summarised in the table below.

Assets	Sector	Buyer	Value	Comments
Public stakes in multiple assets	Diverse	PIF (Saudi Arabia)	USD 1,3 billions	Deal completed in July 2023
ELAB, EDC, and ETHYDCO	Steel	ADQ (UAE)	USD 800 millions	Deal completed in August 2023 and money transfered in November 2023
7 hotels combined into one holding company	Tourism	Talaat Moustafa (Egyptian real estate strategic investor)	USD 800 millions	Deal completed in August 2023 and money transfered in November 2023
Eastern Company	Tabac	Global Investment Holding (UAE)	USD 650 millions + USD 150 millions to finance tobacco imports	Deal completed in August 2023 and money transfered in November 2023
31% of public stakes in Ezz Dekheila	Steel	Ezz Steel (Egyptian steel strategic investor)	USD 245 millions	2/3rd of the money is transfered from abroad in September 2023

Saudi Arabia and the United Arab Emirates are the main strategic partners. But owing to its size and the fact that it was negotiated discreetly and directly, outside the privatisation programme, the Ras Al-Hekma development agreement looks more like a rescue package. It appears that the UAE then took the lead to play the role of "lender of last resort" expected by the market from the Gulf partners.

The last exchange rate adjustment apparently convinced economic agents and investors. Having suspended its financing in March 2023, the IMF also lent greater credibility to the turning point on the exchange rate policy by approving the first two reviews of the programme, which was increased considerably to $8bn from the initial $3bn. This was reflected in the price of CDS, which fell considerably starting in March 2023. Lastly, foreign investors made a spectacular return to the pound Treasury market, injecting nearly $20bn between February and March according to the latest central bank report, a clear indicator of short-term confidence in the pound,

What risks hang over this renewed confidence?

Restoring confidence in the pound has proved costly for Egypt, with a further devaluation of nearly 40% and a severe tightening of interest rates (+800bp since January), further increasing the already high cost of public debt. The latter reached 96% of GDP in 2023 and requires even stricter fiscal discipline.

Unfavourable debt trend to be monitored

Egypt successfully reduced public debt between 2017 (98% of GDP) and 2019 (80%). While high inflation helped diluting fiscal spending in real terms, fiscal consolidation was achieved through courageous budget reforms. In particular, the government withdrew long-standing energy subsidies and significantly reduced food subsidies.

But the gains from this consolidation effort were wiped out by the COVID pandemic and the liquidity crisis. Debt returned to 96% of GDP in 2023 as devaluations inflated the external debt burden. Largely negative real interest rates has so far kept the public debt trajectory manageable

But this trend was reversed by the severe tightening of interest rates – a prerequisite for exchange rate adjustment. Real interest rates moved back into positive territory, creating an upward debt dynamic. The reversal of this trajectory hinged on resilient economic growth and ambitious primary budget surpluses (before interest payments). A deviation from this growth path would raise the threshold of the primary fiscal surplus required to stabilise debt. The fiscal space to meet this threshold would then be extremely limited.

The IMF's revised programme therefore called for a highly demanding reinforcement of the primary surplus, rising continuously from 2.1% in 2024 to 5% in 2027[7]. This is double the medium-term objective set in the initial programme, despite the contribution from public assets sale's receipts, half of which will be used to reduce debt.

Revised programme	2023/24	2024/25	2025/26	2026/27
GDP growth	3.0	4.4	4.7	5.1
Primary surplus (% of GDP)	2.1	3.5	4.5	5.0
Debt/GDP (%)	99.0	85.3	79.9	73.6

Initial programme	2023/24	2024/25	2025/26	2026/27
GDP growth	5.3	5.7	5.9	5.9
Primary surplus (% of GDP)	2.1	2.3	2.3	2.4
Debt/GDP (%)	89.8	88.1	85.8	82.9

[5] The settlement was made in two tranches: the first immediate closing of $15bn, of which $5bn through the conversion of UAE central bank deposits into investment. The second tranche, made in mid-May, totalled $20bn, including $6bn through new deposit conversion.

[6] The banks' net foreign assets, which fell to a negative position of $17.5bn in February 2024, also recovered to a negative $2.8bn in March.

[7] IMF programme objectives, excluding revenues from sales of public assets (including Ras Al-Hekma).

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This stringent requirement reflects the IMF's debt sustainability analysis, which assesses that the Egyptian debt is "sustainable, but not with a high probability."[8]

Fiscal consolidation in 2016-2019 demonstrated the authorities' ability to implement politically difficult fiscal reforms. But an interest-to-income ratio, that Fitch forecast at68% in FY 2025, indicates that fiscal rigidity has increased significantly since 2016, leaving little room for cutting spending. **As a result, stabilising the public debt trajectory calls for a substantial increase in taxes. This is a difficult exercise, with less predictable outcome and that could prove inflationary.**

The government has little fiscal headroom to absorb the impacts of new exchange rate shocks on a middle class impoverished by two years of crisis and inflation. In 2019, one-third of the Egyptian population lived below the national poverty line and the World Bank[9] estimated that a further one-third of the population was vulnerable and likely to fall into poverty. **The question, then, is not simply about having a flexible exchange rate. It is about limiting the effects of this flexibility on the population without using up the country's remaining budgetary resources.** It is only on that condition that Egypt can deliver on its promise of a sustainable transition to a flexible exchange rate.

Besides, the IMF's support based on a partnership with the Gulf countries has allowed to re-anchor expectations, but it did not erase all risks and vulnerabilities. The first concern comes from the time lag between the foreign exchange regime reform and the liberalisation of the economy. This involves the disengagement of the State and the military with a view to improving the business climate and fostering investment. The problem is the "stock of confidence" in the transition to flexible exchange rates – promised three times now – has already been eroded. **The main economic policy challenge for the Egyptian government lies in managing the combined effect of high public debt in the medium term and memories of the liquidity crises and repeated devaluations having eroded confidence in the country's economic governance.** The latter have generated a short-term dynamic that hampers investment, export competitiveness and the reduction of the trade deficit.

Consequently, the Gulf partners, the IMF and the Egyptian authorities are working together on restoring confidence durably to extend investor expectations, the aim being to trigger a virtuous circle of growth and financing of external accounts and public debt. Stabilising market expectations will be more central than ever to the central bank's objectives.

What to keep an eye on?

Risks to external liquidity and Egypt's ability to meet its dollar obligations have diminished significantly in the short term. The financing from the UAE and the IMF (and the additional official financing catalysed by the latter[10]) and the return of portfolio investments give Egypt room to breathe. They will enable the authorities to emerge from a crisis management mode, which all in all they have pulled off, thanks in particular to the coordination of the central bank and the Ministry of Finance. But the country now has to take advantage of that breathing room, while expectations are positive, to move ahead with reforms that are essential to rebuilding lasting confidence. A few indicators around identified risks will be useful to measure success on this score.

1/ The risk of "backtracking" on the transition to a sustainably flexible exchange rate. Confidence in this promise is eroded, and the spiral of negative expectations, from which Egypt is finally emerging, could easily resume if signs of currency rigidity were to reappear. To guard against this risk, the revised IMF program proposes the monitoring of numerous indicators, including the widening of the parallel market premium, foreign exchange demand backlogs at commercial banks, and the foreign exchange turnover in the interbank market. A close eye also needs to be kept on the net foreign assets at banks, because in the past, a sharp deterioration has always preceded a devaluation. Lastly, any further delay in the approval of the programme reviews by the IMF would be an alarming signal, as these reviews are essential to anchoring investor confidence in the continuity of reforms.

2/ The risk of budget slippage. Debt trajectory is unfavourable, so there is little room to absorb fiscal slippage. The government's ability to expand the tax base will be vital to successful fiscal consolidation. Further, if phasing of subsidies as requested by the IMF proves too difficult politically, the Egyptian government will have to find other budgetary savings measures to remain on objective.

3/ The risk of losing control over inflation. Hovering around 30% for the past year and a half, inflation has permanently weakened the country's socio-economic balance and is also putting

[8] "First and Second Reviews under the Extended Arrangement under the Extended Fund Facility – Annex II. Sovereign Risk and Debt Sustainability Framework" IMF, April 2024.

[9] "Understanding Poverty and Inequality in Egypt" World Bank, June 2019.

[10] €7.4bn paid over three years by the European Union, including €5bn in concessional loans to Egypt and €600m in grants. €700m in World Bank financing announced in June 2024, taking the form of budget support (Development Policy Financing - DPF).

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downwards pressure on the pound. The situation calls for the monitoring of the ability of the central bank to maintain an appropriate and independent monetary policy. This will involve high interest rates (and positive real rates) and control of the money supply, notably by maintaining the government's overdraft position at the central bank within legal limits.

4/ The risk of inertia on the reform of private sector development and the business climate. To reduce the economy's exposure to currency crises, foundations need to be laid for a more balanced growth model. To that end, Egypt has promised to partially disengage the state and military sector from the economy, continue asset privatisation, and improve the business climate, competitive environment and remove non-tariff trade barriers. Close attention thus needs to be paid to whether the influx of liquidity (and notably the enormous Ras Al-Hekma contract) will reduce the government's incentives to move forward on these reforms. An eye also needs to be kept on the quality of the growth created by these investments, the risk being a concentration on unproductive sectors (tourism, construction, real estate, etc.) that would not serve to reduce poverty.

5/ The risk of losing "too big to fail" and Gulf's support narrative credibility. The dramatic intervention by the UAE has reinforced the markets' perception of the Gulf's "lender of last resort" status for Egypt. This perception plays a major role in stabilising confidence in regions of high sovereign risk. But a mismatch could emerge between market expectations and the domestic political priorities of GCC countries.

6 / Political and geopolitical risk. Internally, the population's capacity to absorb the costs of crises and reforms has been tested. Subsidy cuts and higher taxes are a major challenge. Political risks would increase significantly if inflation were to remain persistently high, if power outages were to continue or if the population were to endure further currency volatility. Lastly, the war in Gaza has made geopolitical risk a major and lasting risk factor for Egypt. ■

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